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THE U.S. INTERNATIONAL IMBALANCES

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDREDTH CONGRESS

FIRST SESSION

OCTOBER 28 AND 30 AND NOVEMBER 5, 1987

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THE U.S. INTERNATIONAL IMBALANCES

WEDNESDAY, OCTOBER 28, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Bingaman; and Representatives Scheuer, Solarz, and McMillan.

Also present: Judith Davison, executive director; and Lee Price, Dan Bond, Steve Quick, Chris Frenze, Jim Klumpner, and John Starrels, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator **Sarbanes**. The committee will come to order.

There are going to be some votes, but I think we're all right to proceed and I do think we'd better get started. Some of the other members will be joining us shortly.

Today the Joint Economic Committee begins hearings, which have been actually scheduled for some time, to review the U.S. trade position as we move into the final quarter of the 1987 calendar year. These hearings will review both the short-term and long-term prospects for the international accounts and will examine in detail the Nation's export performance.

The hearings were planned at the time the committee issued a midyear report entitled "The Economy at Midyear: A Legacy of Debt," which underscored in particular the shift in the United States net external asset balance which has seen us go from being the world's largest creditor nation to being the world's largest debtor nation. And we pointed out in that study that we have been skating on thin ice and that cracks were beginning to appear in that ice. One of the most prominent of these is the enormous burden of the international debt that the United States had acquired over the past few years.

It's interesting in that light to note that only this week Hobart Rowan, the very distinguished economics writer for the Washington Post, noted with respect to the movements in the stock market—and I'm quoting him—"Then on Wednesday, October 14, that something the stock market had been waiting for happened. Early that day the Commerce Department published a long awaited report on the Nation's merchandise trade deficit showing that the deficit in August had narrowed only to $15.68 billion from $16.47 billion in July. Worst of all, there was no improvement in exports. The result that day was a record drop at that time of 95 points in the Dow Jones Industrial Average. The trade report was widely seen as evidence that the trade gap was not closing as the administration had expected."

Obviously, the improvement in the trade deficit forecast by the administration, by Chairman Sprinkel of the Council of Economic Advisers when he was here before the committee, has not occurred. We confront continuing trade deficits and a growing U.S. foreign debt which have been persistent warning signals with respect to the future course of the economy.

The quote I just read and the events in the market over the past 2 weeks make clear how profound the uncertainties about the economy really are.

The U.S. trade deficit has a direct connection to the financial markets. We borrow from abroad to finance almost the entire trade deficit, and larger trade deficits mean even greater foreign borrowing. Increased U.S. borrowing abroad puts upward pressure on U.S. interest rates and downward pressure on the exchange rate of the dollar, thereby raising questions about the future strength of the economy.

The trade deficit, I might underscore, is a new phenomenon in modern U.S. economic history. From World War I until 1981, the United States was a net creditor nation. While we had run merchandise trade deficits for most of the last 16 years, the United States enjoyed sufficiently large surpluses from investment earnings and services trade to offset the merchandise trade deficit and permit a current account surplus.

As a result, we steadily built up our position as the world's strongest creditor nation. But since 1981, the U.S. trade balance has sunk steadily and in the process has brought down our current account and international creditor position with it. Today our annual trade deficit and foreign borrowing each amount to 4 percent of our GNP.

In part, the deterioration of our trade position reflected the gross overvaluation of the dollar, a situation which was permitted to continue for 4 long years. At the dollar's peak in 1985, the U.S. annual trade deficit reached $134 billion.

Unfortunately, 2½ years later, despite decline in the dollar's value relative to certain key currencies, the trade deficit continues to run at a very high figure. Import prices have risen much less than might reasonably have been expected and improved export performance in volume terms, which has taken place, has not been accompanied by an improvement in the nominal trade deficit, which is, of course, the measure which determines our foreign debt obligations.

These hearings will provide an opportunity for careful review of recent development and probable future trends in our trade accounts. Today's hearing will focus on shorter term questions, including prospects for exports and imports, the failure of the dollar's sharp decline to produce the anticipated improvement in our international accounts, and the interconnections of our trade deficits, foreign borrowing and the financial markets.

At the next hearing on Friday, we will hear a further analysis from Under Secretary Robert Ortner of the Commerce Department; and then proceed to a review of the longer term risks and costs to the U.S. economy of the extreme imbalances in our accounts. We will have Anthony Solomon, chairman of the board of S.G. Warburg and former chairman of the Federal Reserve Bank of New York; and Stephen Marris, as the other witnesses that day.

Then the following week we will review some of the structural factors affecting our trade position.

We are very pleased to have three very able witnesses with us this morning: Paul Krugman, international economist for the National Bureau of Economic Research, and professor at the Massachusetts Institute of Technology; Jerry Jasinowski, executive vice president of the National Association of Manufacturers; and Robert Hormats, formerly a high ranking official in the Government here and now vice president of Goldman Sachs & Co.

Before we begin, I am going to insert in the hearing record the written opening statements of Senators Bingaman and D'Amato, at their request, at this point.

[The written opening statements follow:]

WRITTEN OPENING STATEMENT OF SENATOR BINGAMAN

Thank you Mr. Chairman. I would like to commend you for these timely hearings.

While I share your concern over recent developments, I am troubled by the focus in the nation on short-term fixes to our trade problems. We did not get ourselves into this situation overnight, and we will not be able to correct our problems with short-term magical "fixes."

Two years ago we were told that "fixing" exchange rates would solve our trade deficit. While it is true that the volume of our trade deficit has decline somewhat, it has not declined anywhere near the amount we had expected. Nor will it decline much in the future. Most studies agree that, at best, the trade deficit will not fall below $100 billion without further action -- something the late Secretary of

Commerce Malcolm Baldrige stated before this Committee earlier this year.

Now we are told that the dollar needs to fall another 20 percent if we are to expect the trade deficit to decline. Yet, the stock market has given a very strong signal of what it thinks of the idea of not defending the dollar and the rise in interest rate that would accompany a declining dollar. It is clear that simply "fixing" exchange rates will not solve the underlying structural problems.

The budget deficit is the other "fix" we have latched on to. The Congress and the Administration are meeting this week to craft a compromise budget deficit reduction plan. I believe this is important. We must reduce the amount of Federal borrowing. But balancing the Federal budget, by itself, will not solve our problems. Nor will we solve the problems through automatic cuts which mindlessly reduce funding for those programs needed to rebuild our competitive position -- such as education and research.

We have also been told that America will grow out of its deficits, both budget and trade. We are, as the President likes to remind us, in the longest peacetime expansion since World War II. Yet, our trade and budget deficits have grown as the economy has grown, not shrunk. Clearly, we cannot just grow our way out of our deficits. According to the

Federal Reserve Board, American industrial capacity utilization was over 81% in September. According to one estimate, America would have to produce at an unheard of rate of 95% of current capacity to supply the demand represented by our trade deficit.

This is not possible. Narrowing our trade deficit without a decrease in demand will require additional capacity. And this takes time. We must face the fact that our current trade deficit, whatever its original causes, is sustained by structural factors in the U.S. economy and that reducing it will require structural changes. I hope that the witnesses will look beyond the short-term fixes and discuss the long-term structural solutions to our trade problems. I look forward to their testimony. Thank you.

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL DISCUSS U.S. TRADE TRENDS AND THEIR IMPLICATIONS ON THE ECONOMY OF THE UNITED STATES.

THE HISTORIC DROP IN THE DOW ON THE NEW YORK STOCK EXCHANGE LAST WEEK HAS FORCED EVERYONE FROM ANALYSTS ON WALL STREET TO GOVERNMENT ECONOMISTS TO TAKE A CLOSER LOOK AT THE EVENTS LEADING TO THE MARKET MELTDOWN. WHILE SOME EVENTS ARE MORE CLEARLY TO BLAME THAN OTHERS, EXPERTS ARE PUZZLED AS TO WHAT SPECIFICALLY IGNITED THE SELLING FRENZY IN THE WORLD'S FINANCIAL MARKETS. IT IS CLEAR THAT ACTIONS NEED TO BE TAKEN TO RESOLVE SOME OF THE MOST FUNDAMENTAL PROBLEMS. THE ENORMOUS BUDGET DEFICIT HAS BEEN LOOMING OVER OUR HEADS FOR YEARS AND IS NOT ABOUT TO DISAPPEAR OVERNIGHT. THE UNPRECEDENTED TRADE DEFICIT HAS NOT DECLINED AS RAPIDLY AS WE HOPED THAT IT WOULD, AND INTEREST RATES HAVE RISEN IN THE PAST FEW WEEKS.

I APPLAUD THE PRESIDENT FOR INITIATING NEGOTIATIONS WITH CONGRESS TO WORK TOWARDS THE RESOLUTION OF SOME OF THE

PROBLEMS THAT I HAVE MENTIONED. A CONCERTED EFFORT ON THE PART OF THE EXECUTIVE AND LEGISLATIVE BRANCHES IS A POSITIVE STEP IN THE RIGHT DIRECTION TO RESOLVING THIS COUNTRY'S FINANCIAL PROBLEMS AND TO RESTORING THE MUCH NEEDED CONFIDENCE BACK INTO THE MARKET.

THE TRADE FIGURES OVER THE PAST TEN MONTHS WHILE NOT DECLINING AS MUCH AS WAS EXPECTED, ARE STILL ENCOURAGING. PROGRESS HAS BEEN MADE ON THE TRADE DEFICIT. WE MUST REMEMBER THAT THE DEFICIT WAS CREATED OVER A PERIOD OF A FEW YEARS, AND IT WILL TAKE TIME BEFORE THE U.S. IS BACK IN THE BLACK.

OUR WITNESSES THIS MORNING ARE SOME OF THIS COUNTRY'S TOP NOTCH ECONOMISTS. I LOOK FORWARD TO THEIR TESTIMONY AS IT WILL UNDOUBTEDLY PROVIDE THIS COMMITTEE WITH VALUABLE INSIGHT INTO RECENT U.S. TRADE TRENDS.

THANK YOU, MR. CHAIRMAN.

Senator SARBANES. Gentlemen, we are very pleased to have you with us. I think we will start with Mr. Jasinowski and then go to Mr. Hormats, and then Mr. Krugman we'll let you conclude the panel's presentation.

STATEMENT OF JERRY JASINOWSKI, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. JASINOWSKI. Thank you very much, Mr. Chairman.

Let me say at the outset that I think your leadership and the committee's leadership on this question of international indebtedness was in the lead with respect to this problem, which although there are many other factors associated with the recent stock market decline as we've outlined in our testimony, the most fundamental cause was the dollar crisis, its relationship to the current account, and international indebtedness problem, which in turn is related to the trade deficit, as you mentioned, the level of U.S. interest rates and the budget deficit.

So it's a pleasure to be back again. We have laid out our analysis of the problem in some detail and we have come up, if you will allow us to, with our recommendations for dealing with the current financial crisis as well as some suggestions with respect to trade.

Senator SARBANES. We will include the full prepared statement in the record and if you want to work the executive summary and your general views on the outlook and your recommendations it would be very helpful.

Mr. JASINOWSKI. Thank you, Mr. Chairman.

Since August 25, the massive decline in the stock market has really reflected a loss in the confidence in the American economy. More specifically, both foreign and domestic investors have shown concern about the ability of the United States to deal with its fiscal deficit and its growing foreign indebtedness, which in turn reflects the seemingly intractable current account deficit.

I and many others have suggested we have turned the corner on trade, and I believe that we have. If you look at the improvements in net real exports, they run about $30 billion over the last three quarters and we project that they will continue through 1988 and that they right now are the principal stimulative force within the economy. Certainly our discussion with manufacturing indicates that interestingly enough manufacturing during this crisis period, Mr. Chairman, has actually strengthened over what it might have been 8 or 9 months ago.

The problem is that notwithstanding those improvements in net real exports which we have identified, the current dollar trade deficit has actually deteriorated by about $15 billion and, therefore, while the improved export volume is now improving domestic growth, the turnaround has not been rapid enough to reduce the current account deficit or the net external trade position.

Here, Mr. Chairman, if I could draw you to the 16th page of the prepared statement, you will see the magnitude of the international indebtedness problem we face. A situation of continuous increases in net foreign indebtedness is unsustainable. As of 1986, the net external investment position of the United States stood at $263 billion, an increase of roughly $152 billion over the previous year.

By comparison, as recently as 1984, the United States was a net external creditor as it has been continuously since the 1920's. The trade estimate given above suggests the current account trade deficit in the area of $140 or $150 billion in 1987, indicating that we will be up to about $400 billion by the end of that year in terms of net external indebtedness, and that even for 1988 as the trade deficit is improving, we are looking at a current account deficit in the range of $100 billion. We are hemorrhaging with respect to our international financial accounts faster than our trade accounts can improve in order to deal with that problem, and that, more than any other factor, has led to the current financial crisis.

Therefore, dealing with that, as we've indicated in our prepared statement, has to do with continued fast improvement in our trade account, reducing the budget deficit which has been part of what has distorted both the interest rates and the trade performance, and that it is clear that if we do not do this we will continue to face further turbulence in financial markets and the risk of a worldwide recession.

In my judgment, however, Mr. Chairman, given the underlying health of the American economy, a recession can be avoided if appropriate steps are taken. We have outlined how serious the economic outlook is, however, by first pointing out the positive elements in the current economic environment. Economic growth was healthy in the third quarter. Trade in terms of real net exports has improved substantially. The industrial economy, again, has strengthened and manufacturing is certainly stronger now than it was a year ago. Interest rates have declined and inflation remains moderate.

Up until the financial crisis, the production side of the economy was actually improving.

Having said that, we have gone and simulated the crash, Mr. Chairman, that occurred in the financial markets, and it is clear that it will have a substantial negative effect on the economic outlook for 1988, both by reducing net real wealth and, more importantly, due to its psychological impact.

Our simulations indicate that in the aftermath of the financial crisis, the likelihood of recession is now about one in three, while even the somewhat more optimistic baseline scenarios show very slow growth in the first and second quarter of next year.

In my opinion, it is clear that the economic conditions are likely to deteriorate sharply enough that the objectives of policy must be aimed at focusing on avoiding such a downturn.

Then, Mr. Chairman, I would like to go through eight recommendations with respect to what ought to be done with respect to avoiding that downturn and avoiding the financial crisis turning into an economic crisis.

First, cease-fire on the rhetorical front is essential in the current crisis environment. Well, it doesn't take an economist to figure this out. It's pretty clear that the constant bickering between the Congress and the President seen on television night after night does not help in this situation.

Second, and more substantively, the Federal Reserve should maintain sufficient liquidity in the system to inhibit further decreases in economic activity. In my view, this will probably require further reductions in interest rates, although as noted below, the need to support the dollar implies a lower limit on the range of interest rate reductions.

Third, adherence to the Louvre agreement or some revised version, if necessary, in order to ensure a measure of stability is retained in foreign exchange markets. The dollar is under great pressure. It's likely to decline in the next year based on market forces. We want to ensure that that decline is gradual and orderly and that requires something like the Louvre agreement in order to achieve that kind of stability, and we need to be very careful about not talking fast and loose and doing things that can jeopardize the dollar because for all the importance of the budget deficit and these other factors it is the dollar that is on the cutting edge of the financial crisis and our future economic outlook, both in the sense of having the potential for improving our competitive situation and also for throwing us into recession.

I might underline, Mr. Chairman, that as people talk about the dollar, they need to pay attention to the fact that the focus has been almost exclusively on the mark and the yen where there has been substantial devaluation, but that represents only about 40 percent of the trading activity of the United States. If there needs to be further dollar adjustment—and I think that there does—the focus ought to be in large measure, as I've indicated in my prepared statement, on bilateral negotiations with those countries where there has been no improvement on the exchange rate.

Fourth, there should be some regulation of program trading but an extensive regulatory effort in financial markets would be self-defeating.

Fifth, a trade bill should be promptly enacted. We need one. Congress has put forward a bill which has many fine provisions in it, but we ought to strip it of any clearly protectionist provisions and get it out and get that part of it settled so that the world, which constantly comes back to us and says "are you going to pass protectionist legislation?" will be reassured that world trade will be maintained.

Sixth, the current tax bills being considered in Congress should be rejected because many of the specific provisions would adversely impact business activity just as we are entering an economic slowdown.

Mr. Chairman, I am compelled here to point out that what's happened with respect to taxes over the last several years, the original $163 billion in tax cuts for business enacted in 1981 has been followed by $218 billion in tax increases since then, for a net tax increase over that period of $55 billion.

Moreover, any major tax increase in fiscal year 1988 should be carefully weighed in terms of the harm that they could have on what is likely to be a slowing economy.

Finally, in the tax area, Congress should also consider lowering the capital gains tax rate inasmuch as this could encourage further participation in the stock market without any revenue loss. I personally have been slow to come to this, Mr. Chairman, because I have not been convinced that there would not be revenue loss. But as I've looked into studies more carefully, I am convinced that it would not reduce revenues and I must say we went very far in capital gains—it won't solve this crisis, but it certainly would be a nice bit of help with respect to investor's confidence.

Seventh, radical measures should be taken to reduce fiscal year 1988 spending, including a freeze on new outlays. Congress and the administration should endeavor to reduce the budget deficit by $23 billion as specified in Gramm-Rudman, and possibly as much as $30 billion.

I have had calls from business leaders and others saying, "You've got to go further. You've got to go further." And what I've said to them, "Gentlemen, let's be sure that we don't overreact for fiscal 1988 and try to reduce the deficit so much that we help throw the economy into recession."

I think, Mr. Chairman, it's essential and realistic and politically feasible to look at this as a multiyear budget deficit reduction program, and what we have said in item No. 7 is that something in the $23 to $30 billion range is about right, and then we ought to look at the outyears and here we have suggested that we ought to have a package that deals with spending and tax reductions on a 2-for-1 ratio because spending has been the principal part of the problem over the last several years, as it has increased as a part of GNP, and that the plan should also spell out spending and revenue changes that would require future actions by the Congress, set up a framework, if you will, and then, since it's going to be very difficult for Congress to deal with some of its politically difficult spending decisions as well as taxes, Congress and the administration should consider a bipartisan commission to assist in this process.

Now I have been reluctant on the commission idea as well, Mr. Chairman, because I think it's important not to be charged with passing the buck, but I think that over a 2- or 3-year period a bipartisan commission like this could look at the difficult spending and tax decisions. It could look at some of the procedural changes, and if chaired by someone of national reputation such as Paul Volcker, it could bring to this whole process an additional aspect of stability and committedness.

Finally, Mr. Chairman, the current financial crisis should underscore the need for a broad commitment to continue to improve our international competitiveness. In large measure, we got into this because of our failure to do well in terms of international competitiveness and our excesses in Wall Street. We ought to ensure that costly new mandated programs are not enacted and that firms continue to improve their productivity, quality and marketing on an accelerated basis.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Jasinowski follows:]

PREPARED STATEMENT OF JERRY JASINOWSKI

EXECUTIVE SUMMARY

Since August 25, the massive decline in the stock market, both in the United States and overseas, has signalled a widespread loss of confidence in the American economy. More specifically, both foreign and domestic investors have shown serious concern about the ability of the United States to deal with its fiscal deficit and its growing foreign indebtedness, which in turn reflects the seemingly intractable current account deficit.

The market's concern over the current account in turn reflects the fact that the current dollar merchandise trade balance has continued to deteriorate in 1987, notwithstanding substantial progress in lowering the deficit on net exports. Over the period 1986:4 through 1987:2, net exports have improved by over $30 billion (in constant 1982 dollars). However, measured at an annual rate, the current dollar trade deficit has actually deteriorated by about $15 billion. Therefore, while the improved export volume is now contributing to domestic growth, the turnaround has not been rapid enough to reduce the current account deficit or the net external debt position.

The two key economic issues for the coming year have to do with the trade accounts and the fiscal deficit. If the American trade and fiscal deficits are put on paths indicating clear progress, this will do much to restore confidence in financial markets. If clear progress toward solutions is not demonstrated, the result will be extreme voltatility in foreign exchange markets, further turbulance in financial markets, and the risk of a worldwide recession. In my judgement, given the underlying health of the American economy, a recession can be avoided if appropriate steps are taken.

The seriousness of our policy decisions is reinforced by the apparent deterioration in the economic outlook. In this respect, the market crash of October 19 has in itself significantly augmented the risk of recession, both by reducing real wealth and more importantly due to the psychological impact. Our simulations of the probable trajectory of the economy in the aftermath of the financial crisis indicates that the likelihood of a recession is now about 30 percent, while even the somewhat more optimistic baseline scenario is for an extended period of weakness to emerge beginning in 1987:4. It is clear that economic conditions will deteriorate sharply enough that policy actions will have to be focused on the objective of avoiding a downturn.

A further dimension of the current situation is political in nature. In crisis situations, psychology plays a substantial role, and in this regard the markets' perception of the ability of the American government to deal with international financial imbalances and the fiscal deficit are of critical importance. Up to the present time, the Administration and the Congress had essentially deadlocked on the budgetary issue, and were unable to agree on any plan for reducing the structural deficit over the long term other than the sequestration provisions in the Gramm-Rudman-Hollings law. With the markets now increasingly nervous over the long-term structural deficit, further political infighting and procrastination will only aggravate the likelihood of additional financial crises. Instead, it is imperative that the Administration and the Congress achieve a workable compromise on deficit reduction. In addition to short-term measures needed in order to achieve the GRH targets for FY 1988, Congress and the Administration need to develop a workable multi-year plan for reducing the Federal deficit, and need to implement this plan in a manner that is sufficiently credible to reassure the markets of their resolve.

At the same time, it is necessary to recognize the positive elements in the current economic environment: economic growth was healthy in the third quarter, trade in terms of real net exports has improved substantially, the industrial economy has strengthened, inflation remains moderate, and interest rates are declining. Up until the financial crisis, the production side of the economy was actually improving.

Given this backdrop, the following steps should be taken to avoid an economic downturn in 1988.

1] It is necessary to end the current deadlock on fiscal policy between Congress and the Administration. To a considerable extent, the budgetary process has degenerated into a cycle of accusations and counter-accusations, which has contributed to the loss of confidence about the American economy. A cease fire on the rhetorical front is essential in the current crisis environment.

2] The Federal Reserve should maintain sufficient liquidity in the system to inhibit further decreases in economic activity; this may require further reductions in interest rates, although as noted below, the need to support the dollar implies a lower limit on the range of interest rate reductions.

3] Adhere to the Louvre agreement, or some revised version, in order to insure that a measure of stability is retained in foreign exchange markets. Bilateral negotiations should be undertaken with the other major industrial countries to insure that central banks support the dollar through intervention, and that more stimulative demand management policies be adopted. Bilateral negotiations with countries where there has been no exchange rate improvement should also be vigorously pursued.

4] There should be some regulation of program trading, but an extensive regulatory effort in financial markets could be self-defeating. The stock market collapse was not caused primarily by insufficient regulation, but rather by the failure of public policy to maintain confidence in the economy.

5] A trade bill should be promptly enacted, stripped of any clearly protectionist provisions. The world needs assurance that international trade will be amplified, not restructured.

6] The current tax bills being considered in Congress should be rejected because many of the specific provisions would adversely impact business activity just as we are entering an economic slowdown. Any major tax rate or excise increases in FY 1988 should be rejected because of the harm they could have on a slowing economy. Congress should also consider lowering the capital gains tax, inasmuch as this would encourage further participation in the stock market without any revenue loss.

7] Radical measures should be taken to reduce FY 1988 spending, including a freeze on new outlays. Congress and the Administration should endeavor to reduce the budget deficit by the $23 billion specified in the current Gramm-Rudman targets, and possibly as much as $30 billion - the larger amount bringing more credibility to the effect of both branches.

8] Beyond FY 1988, what is needed is a systematic plan for reducing budget deficits over a two to three year period. The emphasis should be on spending reduction, on at least a 2 for 1 ratio of spending reductions to revenue increases, since spending has escalated as a share of GNP during the 1980s, while the tax ratio to GNP is still roughly the same as in the last decade. This plan should spell out spending and revenue changes that would require future actions by the Congress. Since it is essential that all spending programs be reviewed, including those that have been politically intractable in the past. Congress and the administration should establish a bi-partisan commission to assist in the development of the specific components of this multi year budget deficit reduction effort as well as to recommend changes in our budget procedures. Included in this review should be the implementation of a line item veto authority for the President. To the extent that tax increases are required, a broad based consumption tax should be considered as a long term reform to stimulate investment, savings and international competitiveness.

Finally, the current financial crisis should underscore the need for a broad commitment to continue to improve our international competitiveness. Costly new mandated programs that impair our ability to compete should be avoided. Firms must continue to improve their productivity, quality and marketing on an accelerated basis.

THE OVERALL ECONOMIC OUTLOOK

The stock market crash has substantially altered the economic outlook. While most econometric models predicted a continuation of slow growth with some correction in the stock market, the October 19 crisis and its after-effects have impelled a significant downward revision of the growth rate over the next three quarters. The October 19 crisis was distinctive not only in the unprecedented magnitude of the decline but also because it was worldwide in nature; the fall that began in New York rapidly spread to the markets throughout the industrial countries. The major causes of the crisis were as follows:

1] An emerging perception that the stock market had become grossly overvalued. The rise in the Dow Jones Industrials (DJI) to 2722 on August 25 was clearly a speculative aberration that was not justified by the fundamentals, implying the need for a correction. This was reinforced by a substantial spread between bond and stock yields. Prior to the crash, the yield on high quality bonds exceeded the earnings yield on the DJI by as much as 500 basis points. This was likely in and of itself to cause a reallocation of funds from stocks to bonds, and hence a decline in the stock market.

2] A diminution in domestic liquidity due to the countercyclical tightening of monetary policy earlier in the year. The growth rate of the broad money supply M2 fell below the rate of inflation during the first half, yielding a small decline in real money balances.

3] Technical factors such as computerized trading, primarily pre-programmed sell orders, and a simultaneous rush by panic-stricken small investors to liquidate stocks held through mutual funds.

4] Most importantly, a genralized investor fear that the American fiscal and current account deficits had effectively gotten out of control and that policymakers in Washington were unable or unwilling to address the problem. This meant a growing loss of confidence in the dollar which, taken in conjunction with the seeming breakdown of negotiations between the United States and Germany over stabilization of interest rates, created a fear that the dollar was going to fall continuously and by substantial magnitudes. The lack of clear direction out of Washington, and the apparent refusal of some political leaders to take the crisis seriously enough, added to the loss of confidence in the political system.

As to why the stock market should deviate so far from the equilibrium levels implied by economic fundamentals, first on the upside and then on the downside, there has in fact been a tendency during the last few years toward an increasing disjunction between the financial sector and the real economy. During the period of industrial stagnation in 1985-86, stock prices were visibly robust. By comparison, the current crash actually coincides with an acceleration in the rate of industrial growth. As noted above, the financial markets appear to have been more influenced by international financial flows, inflation expectations and the exchange rate, with a lesser role for physical production in the domestic economy.

Even assuming stabilization of stock markets here and abroad, whether at current levels or after a compensatory technical rally, the collapse in equity values has significantly augmented the likelihood of a recession in 1988. The mechanisms underlying the possible emergence of recession are as follows. First, the fall in equity values reduces real wealth for both business and consumers. Even more important than the effects on wealth, however, are the psychological effects on consumer and business expectations. Investors will be enervated, and will probably keep their funds in safer liquid assets such as bonds and T-bills. Consumer pessimism, already in evidence following an unsustainable surge in spending in the third quarter, will increase further just before the critical holiday season. Business will scale back investment plans. Therefore, a significant slowdown in consumption spending, coupled with a major decline in capital formation should be expected in the fourth quarter. The effects on growth will however be partly offset by countercyclical movements in trade and inventories, and by the Federal Reserve's shift to a looser monetary policy in an effort to prevent a liquidity squeeze from sending markets into another selling panic.

The stock market collapse will have two effects on trade, one positive, the other negative. The positive effect is that imports will decline in the wake of weaker spending. The negative effect is that because the crisis was worldwide, demand for American exports will also fall. This implies a significant reduction in the forecasted trajectories for both exports and imports.

We have simulated two possible scenarios resulting from the stock market crisis. In the baseline, the economy undergoes a slowdown starting in 1987:4, characterized by pervasive weakness in domestic spending. The growth rate actually turns slightly negative in 1988:1, but the economy begins to recover in the second half of 1988. The normal definition of a recession -- two quarters of negative growth in GNP -- militates against terming the baseline a recession, although it should be noted that industrial production and manufacturing output experience three quarters of negative growth. The second scenario is an alternative to the baseline forecast of slow growth, in which the economy plunges into recession around the start of 1988. In this simulation, fears of a devaluation crisis push interest rates higher, and domestic spending falls more rapidly as a result of a general loss of confidence. Global demand also falls as the effects of the recession in the United States are transmitted overseas. The economy experiences two quarters of negative growth in 1988. Despite the magnitude of the stock market crisis, we assign a subjective probability of about 70 percent to the baseline forecast and only about 30 percent to the early recession scenario. The trade forecast given below in Table 1 is taken directly from the baseline.

RECENT DEVELOPMENTS IN TRADE

Prior to analyzing the trade forecast numbers in detail, however, it is necessary to review recent developments in the trade sector. The conflicting reports given by real net exports and current dollar merchandise trade have led to some debate as to which is the preferable measure of the economy's trade performance. In my view, the optimal measure of external trade from the standpoint of forecasting domestic economic activity is net exports in constant dollars, since it more closely approximates the volume of goods and services traded, and determines the contribution of the external sector to aggregate output.

It should be noted here that the growth in real exports reflects an overall current-dollar growth rate of 11 percent in manufactured goods, which comprise about three quarters of all exports. Unfortunately, the current-dollar value of imports has also continued to grow, by about 7 percent, and this has meant no reversal in the negative current account trend. In this respect, the current account deficit measures the amount which must be borrowed from abroad in order to finance current dollar expenditures on trade, and therefore is the key determinant of external indebtedness. Further, the current dollar trade figures appear to have exerted a stronger psychological impact on financial markets, as the October 19 stock market crisis has demonstrated.

Using the real net exports series, several developments are immediately apparent. First, the deficit reached its apex in 1986:3, at -$161 billion, and has declined sharply since this time, to -$133 billion in 1987:2. This was accounted for by a significant rise in exports and a corresponding slowdown in import growth. Exports rose from $370 billion in 1986:2 to $414 billion in 1987:2, an increase of $44 billion in constant dollars. Imports almost levelled off during the same period, increasing from $540 billion in 1986:3 to $547 billion in 1987:2. The preliminary report for the third quarter of 1987, however, actually showed a deterioration in net exports of some -$5.2 billion. Exports continued to show robust growth, increasing by over $16 billion, but imports increased more rapidly, by $21 billion. Nevertheless, this deterioration in net exports is actually less serious than it appears, since over $19 billion of the increase in imports was accounted for by petroleum rather than by manufactured goods.

With respect to product categories, the increase in merchandise exports so far has occurred primarily in two sectors, chemicals and aircraft, which have increased by $2.3 billion and $2 billion respectively (in current dollars) in 1987. Falling imports and modest exports growth also led to a $700 million improvement in power-generating machinery. There was also a $1.3 turnaround in automotive parts, although this category largely reflects trade with Canada. In most other sectors, exports have actually increased at a higher percentage rate than imports. Only in clothing and cars have imports actually increased more rapidly, and in the automotive sector, this appears to be more of a volume than a price phenomenon.

Despite the favorable developments in real net exports, however, as noted above the current account has actually deteriorated. This has raised considerable doubt in investors' minds as to how rapidly the balance of payments position is going to improve. While the projections given below are fairly optimistic by historical standards, they may not be sufficiently favorable to reassure financial markets, with the result that an exchange rate crisis may take place even in the presence of sustained gains in net exports.

TRADE PROJECTIONS

The forecasted values for real exports and imports, broken down into merchandise, services, agricultural exports and petroleum imports, are given in Table 1. These forcast numbers were worked up prior to the release of the GNP report on October 23, and therefore make somewhat more optimitic assumptions with respect to oil imports in the third quarter.

TABLE 1

NAM Trade Forecast

	Actual		Forecast						Annual	
	1987.1	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1987	1988
Net Exports, 1982 Dollars	-135.2	-132.7	-134.2	-118.5	-100.8	-91.7	-77.9	66.1	-130.2	-84.1
Exports	397.8	414.5	425.2	442.4	454.8	457.0	468.7	480.6	420.0	465.3
Exports, Merchandise	227.4	236.4	240.3	253.2	263.4	262.4	270.5	278.2	239.3	268.6
Exports, Agriculture	31.2	34.1	35.6	37.1	37.6	38.7	39.9	41.2	34.5	39.4
Exports, Services	139.2	144.0	149.4	152.0	153.7	156.0	158.3	161.2	146.1	157.3
Imports	533.0	547.2	559.5	560.9	555.6	548.7	546.6	546.7	550.1	549.4
Imports. Merchandise	355.7	360.7	365.9	366.3	361.1	354.2	351.5	350.3	362.1	354.3
Imports. Petroleum	69.5	72.1	78.5	78.2	77.7	77.6	77.7	77.9	74.6	77.7
Imports. Services	107.8	114.4	115.1	116.4	116.7	117.0	117.4	118.5	113.4	117.4
Exchange Rate (index)	99.9	97.0	94.2	92.5	89.7	87.4	85.4	83.7	95.9	86.6
Net Exports. Current Dlrs	-112.2	-118.4	-123.2	-112.1	-100.8	-94.8	-83.6	-75.4	-116.5	-88.7
Exports. Current Dollars	397.3	416.6	434.1	458.6	478.9	490.8	511.9	532.4	426.6	503.5
Imports. Current Dollars	509.5	534.8	557.4	570.7	579.8	585.6	595.6	607.8	543.1	592.2

Forecast run using the Washington University Macromodel.

Nevertheless, the overall magnitudes for 1987-88 are not seriously affected by the worse-than-expected performance of third quarter net exports. The pattern of the improvement that is projected here relies on slower but continuous gains in exports, coupled with a diminution of the real import volume. Exports rise from $414 billion in 1987:2 to $480 billion in 1988:4, an improvement of $66 billion over six quarters. The most significant gains are in merchandise, which increase by $41 billion. Agricultural exports grow minimally; despite the price advantage enjoyed by American agricultural products on world markets, the current surplus of commodities inhibits faster gains. Service exports also witness an improvement, growing by $17 billion. Imports grow more slowly, rising from $547 billion in 1987:2 to $561 billion in 1987:4 before declining to $546 billion in 1988:4. On an annual basis, real net exports improve by 46 billion in 1988. The year-over-year improvement actually understates the magnitude of the quarterly gains. Between 1987:2 and 1988:4, the economy achieves a net export improvement of $67 billion. If this may at first sight appear unrealistically sanguine, it should be borne in mind that over the last three quarters, net exports have improved by over $30 billion. An improvement of $65 billion in six quarters therefore requires nothing more than a continuation of the existing trends.

Developments in world oil markets introduce an element of uncertainty into the trade forecast. Some of the massive swings in net exports reported over the last year have been due to speculative volatility in oil markets. For instance, imports were higher than expected in late 1986 due in part to precautionary stockpiling of petroleum, while imports fell in early 1987 in part due to liquidation of surplus oil stocks. This speculative volatility has been aggravated by the current situation in the Persian Gulf, which probably underlay the buildup in oil inventories in the third quarter.

It should be noted that there are a series of minor factors which will mitigate the trade improvement. First, foreign suppliers are likely to attempt to hold onto their share of the American market by pricing their goods in an unusually competitive fashion. Second, any number of foreign countries are still limiting market access to American goods. Particularly in Japan and in the Pacific Basin, any number of non-tariff barriers have been used to keep American goods out of local markets. It is only recently that the newly industrialized Pacific nations, such as Taiwan and South Korea have begun to increase their purchases of American goods, and largely out of fear of retaliatory protectionist measures. Notwithstanding recent efforts on the part of these countries to reduce their trade surpluses, however, formidable barriers to entry remain, ranging from state-run industrial policies which give preferential treatment to domestic firms to regulatory requirements and nationalistic sentiment on the part of foreign consumers. Finally, it should be noted that the devaluation of the dollar since early 1985 has been asymmetric with respect to foreign countries. Most of the devaluation has taken place against Japan and the EMS countries, which account for about 36 percent of American trade. Against Canada, which accounts for some 20 percent of trade, the American dollar has fallen little. The dollar has actually appreciated against some of the weak currencies of debt-ridden Latin American nations. Against the newly industrialized Asian countries, the dollar has declined only very minimally. Taiwan has revalued against the dollar by about 20 percent during the last twelve months, but South Korea's exchange rate has undergone only minimal appreciation, about 9 percent since 1985. The current American pressure on Japan may induce South Korea to revalue further. Until the exchange rate is bilaterally adjusted against individual trading partners, however, the United States will continue to be in the position of being selectively overvalued.

IMPLICATIONS FOR MACROECONOMIC POLICY OVERSEAS

Prior to the stock market crisis, it appeared that the United States would make little progress in inducing the other large industrial countries to adopt more stimulative macroeconomic policies. In this respect, one of the disappointing results of the recent Venice economic summit was the failure of a consensus to emerge on stimulating higher world growth. Apart from some unenforceable and largely ineffectual agreements about improved coordination of economic policy, the United States was not able to extract any commitments for more stimulative macroeconomic policies. However, the stock market crisis overseas may impel loosening moves in other countries.

The critical policy variables will be the course of demand management in Europe and Japan. European macroeconomic policy has typically tended to be dominated by Germany, since the other EMS countries must tie their currencies to the mark. Because of Germany's historic orthodoxy in monetary and fiscal policy, this implies that the European community as a whole has been forced to emphasize inflation control. However, in the wake of the crisis, Germany and the United States may agree on the need for greater reflation in the EEC. Immediately prior to the crisis, the president of the German Federal Bank rebuffed American requests for stimulus and indicated that it would raise interest rates. However, the German Federal Bank is now reassessing this position, and the German government may accelerate a planned package of tax reductions. If Germany reflates, this will allow the other large European countries to also follow less restrictive macroeconomic policies, although France and Italy are constrained from actual reflation because of their higher inflation rates. Similarly, in England (which is not part of the EMS), the central bank is likely to undertake loosening measures, since the decline of the London stock market was actually greater than in New York. The Bank of England is well aware of the need to restore confidence in financial markets, since the London stock exchange is the world's center for internationally traded equities. Further, the British inflation rate is sufficiently low relative to the rest of Europe that this country has some room for reflation.

In Japan also policies may be gradually shifting toward a looser fiscal stance. Up to now, however, the prevailing consensus in this country has been in favor of a policy mix consisting of mercantilistic trade practices and restrictive management of domestic demand. Moreover, policy changes in Japan typically take place quite slowly inasmuch as leadership in this country is essentially collegial, yielding chronic tendencies toward bureaucratic inertia. Notwithstanding the ostensible improvement in the Japanese willingness to cooperate with its trading partners, it is still unclear to what extent major policy changes will take place in this country, and what effects they will have on the trade deficit.

FOREIGN DEBT, GLOBAL CAPITAL FLOWS AND THE DOLLAR

While from the standpoint of trade flows a further depreciation of the dollar would be in order, at least against individual countries, it should be noted that there are other reasons why only a gradual and orderly devaluation is appropriate. The reasons go back to the dependence of the United States on capital imports. Because a rapid devaluation in the dollar would reduce the real value of foreign investments in this country, foreign investors will continue to move their capital into the United States only if they can be assured of a reasonable rate of return, and this presupposes only a gradual rate of devaluation.

The dependence of the United States on capital imports owes to two major causes. First, the domestic savings rate has been inadequate. Over the last two years, total saving, i.e., private sector saving and the state and local government surplus has come to approximately 7 percent of GNP. Most of the private sector's saving is by business, with the individual savings rate falling to just over 2 percent of disposable income in 1987:3. Not only has the private sector's savings rate been too low, the recent fall in the savings rate has been accompanied by a massive buildup in debt, both by consumers and by corporations. The second problem has to to with the structural fiscal deficits being run by the Federal government. In FY 1986, the Federal deficit amounted to a net dissaving of -4.9 percent of GNP. As of FY 1987, this declined to approximately -3.5 percent of GNP, but the reduction in the deficit this year has been attributable primarily to a series of one-time-only factors. In subsequent years, the fiscal deficit will tend to increase in real terms under current policy, meaning in essence that any reduction in the deficit will require further changes in spending programs or tax revenues. The upshot is that net domestic savings -- the sum of private savings and the combined government deficit -- has been inadequate to cover domestic borrowing requirements. An intractable crowding out problem in credit markets has been avoided only due to the inflow of foreign capital.

While some commentators have argued that the Federal deficit is not the primary cause of the capital inflow, on the grounds that less than one fifth of foreign investment has actually been directed into Treasury securities, this distinction is in fact meaningless: what is at stake here is the total magnitude of American demand for credit relative to the domestic supply. The mere fact that the Federal government is expected to run deficits of 3.5 to 4 percent of GNP well into the next decade will either force the private sector out of capital markets or heighten the foreign indebtedness of the United States.

In the long-term, a situation of continuous increases in net foreign indebtedness is unsustainable. As of 1986, the net external investment position of the United States stood at -$263.6 billion, an increase of $151.7 billion over the previous year. By comparison, as recently as 1984, the United States was a net external creditor, as it had been continuously since the 1920s. The trade estimates given above suggest a current account deficit in the area of $140 to $150 billion in 1987, implying that the net external debt will surpass $400 billion by the end of the year. The large trade improvement forecast for 1988 will engender a reduction in the current account deficit that year, but it could still be in the range of $100 billion. If the current account deficit is forecasted out to 1990 by a process of simple extrapolation, the net foreign debt of the United States would reach $800 billion by the end of the decade. If this does in fact take place, payments on on the debt would rise to $60 to $70 billion a year, not an inconsiderable magnitude.

However, such simple extrapolative techniques may well be inappropriate here, since well before the foreign debt reaches this magnitude, it could trigger a collapse in the exchange rate and a renewed international financial crisis. The United States has been able to incur net debtor status without a collapse in its exchange rate up to now primarily because of its unique position as the world's reserve currency country. Since the dollar is accepted as a medium of exchange worldwide, and since the debt is denominated in dollars, the United States enjoys the luxury of being able to to pay its debt by issuing reserve currency, rather than by generating additional exports. Nevertheless, this is subject of course to the willingness of foreign countries to continue to hold dollar-denominated assets. This caveat underlines the fundamental danger associated with net debtor status. The world's financial markets are fully cognizant of the inherent risks of the debt buildup; as noted earlier, it was principally the fear of a devaluation crisis that set off the October 19 collapse in stock prices.

There is some evidence that the preconditions for an exchange rate crisis already exist. Net private capital flows into the United States diminished substantially in 1987:1, when the bulk of American foreign debt was absorbed by foreign central banks. However, reserve inflows resumed in 1987:2, and the third quarter is not yet available. Nevertheless, the diminution of capital flows on average has made the stability of the exchange rate contingent on continued purchases of dollar-denominated assets by the central banks of the other industrial countries. In the event that agreements among central bankers to manage the dollar were to break down, there would be a serious risk of a massive drop in the exchange rate, which could only be halted by substantial increases in domestic interest rates.

In order to gauge the implications of this type of scenario, we simulated a hypothetical trajectory in which the exchange rate declined by -25 percent in a single quarter in early 1988. In the event that the Federal Reserve were to accommodate this decline, the implied increase in the inflation rate is for the GNP Deflator to surpass 9 percent by early 1989, with long-term interest rates reaching 15 percent late that year. As a result, monetary policy was assumed to become restrictive. As a result, the rise in inflation was held to 6 percent through the repression of domestic demand. Interest rates, however, underwent substantial increases, with the prime hitting 12 percent by the end of the year. As a result, the economy went into recession, with three quarters of negative growth, in which the magnitude of the decline ranged from -1.5 to -3.5 percent per quarter at an annual rate. Interestingly enough, the trade deficit underwent a spectacular improvement, due both the the lower exchange rate and the fall in domestic demand. However, even the gain of an additional $20 billion on net exports in 1988 was not sufficient to avert the recession.

This hypothetical scenario is outlined primarily in order to illustrate the risks associated with a collapse in the dollar. At the current time, we still assign a modest subjective probablility to this type of development, on the assumption that the Federal Reserve will attempt to prevent a crisis both by intervention in foreign exchange markets and if necessary by raising interest rates. Nevertheless, the risk of a crisis is cearly higher in the wake of the stock market collapse, since monetary policy has had to be loosened in order to prevent domestic liquidity constraints from aggravating the decline in equity values. Moreover, as the external debt position of the United States continues to deteriorate, the risk of an exchange rate crisis of this type cannot be ruled out in future years.

CONCLUSIONS

The stock market crisis and the increasing fragility of international financial markets heighten the need for a more radical plan of action with respect to the fiscal deficit. Much of the underlying anxiety in financial markets can be attributed to the projected effects of the structural fiscal deficit -- chronic pressure on interest rates and endemic increases in foreign indebtedness. In this respect, the markets are implicitly demanding a more credible commitment to deficit reduction. While the sequestration mechanism in the revised Gramm-Rudman-Hollings law should contribute to deficit reduction, the apparent deadlock between the Administration and the Congress over how to achieve lower deficits seems to have fatally undermined investor confidence. In financial crises such as the October debacle, expectations inevitably play a powerful role. Consequently, in the event that Congress and the Administration were to jointly take credible actions to reduce the fiscal deficit, this would have a salutary effect on investor expectations, and would do much to assuage the current fears in financial markets that the deficit is inherently intractable. The need for remedial fiscal action is underlined by the fact that monetary policy is caught on the horns of a dilemma, and cannot handle the task of stabilizing markets on its own. If domestic liquidity is expanded and interest rates are lowered too rapidly in order to inhibit a further decline in the stock market, this will sooner or later lead to downward pressure on the exchange rate, which could increase the risk of further turbulence in securities markets. Conversely, if interest rates are raised to support the dollar, this will not only slow the improvement in trade, it could trigger further stock market selling, due to the fear of recession. In the short-term, the Federal Reserve can achieve both greater exchange rate stability and expansion of domestic liquidity through intervention in foreign exchange markets. When intervention is not offset by domestic open market operations, this will tend to expand the domestic money supply. However, in the long-run, intervention is not a viable solution, since its effect is limited to inducing near-term deviations from the market path of exchange rates. In this sense, the range of long-term policy choices confronting the Federal Reserve is inherently unfavorable. The Federal Reserve is caught between the Scylla of defending the dollar but risking throwing the economy into recession, and the Charybdis of an exchange rate crisis which would inevitably also be followed by restrictive actions and a downturn in the business cycle. Given this range of alternatives, the resolution of the current situation will have to emanate primarily from greater fiscal restraint.

Specifically, NAM recommends a more substantial plan of action on reduction in the deficit than has heretofore been adopted. First, there is the need for a multi-year approach to the budget. The Gramm-Rudman-Hollings targets represent a useful step in this direction, but are not adequate in and of themselves. While they specify aggregate targets, they do not specify reductions in specific categories. Moreover, in the event that targets are not met, the GRH sequestration process calls for reductions that theoretically take place on an across-the-board basis but are in actuality selective inasmuch as specific programs have been exempted. By exempting specific programs, Congress is in effect stating that some categories of Federal spending should be immune from the sacrifices entailed in the deficit reduction process. No programs should be immune.

For all the problems associated with GRH, however, the actual target of a $23 billion reduction in the deficit in FY 1988 is not an unreasonable range, although increasing the target to $30 billion would have a salutary impact on financial markets. If the deficit is reduced too rapidly, however, the process of fiscal restraint in and of itself could throw the economy into recession.

Beyond fiscal 1988, what is needed is a systematic plan for reducing deficits over a 2 to 3 year period. The emphasis should be on spending reduction, or at least a 2 for 1 ratio of spending reductions to revenue increases, since spending has escalated as a share of GNP during the 1980s, while the tax ratio to GNP is still roughtly the same as in the last decade. This plan should spell out spending and revenue changes that would require future actions by the Congress. Since it is essential that all spending programs be reviewed, including those that have been politically intractable in the past, Congress and the administration should establish a bi-partisan commission to assist in the development of the specific components of this five year budget deficit reduction effort, as well as to recommend changes in our budget procedures. The commission should be given the broadest possible mandate and chaired by an eminent citizen that could inspire confidence during these times, such as fomer Federal Reserve Board Chairman Paul Volcker.

With respect to tax increases, the tax provisions contained in the current House Ways and Means revenue bill, such as an increase in the corporate minimum tax, are inequitably punitive toward the business sector. In this respect, while business received only a disproportionately small share of the original tax reduction under ERTA in 1981, business has had to bear a disproportionately high share of the tax increases contained in TEFRA in 1982, the Tax Reform Act of 1984 and the Tax Reform Act of 1986. The dangers of further raising taxes on business, at a time when the economy may well be on the verge of recession, should not be underestimated.

However, since it may not be politically realistic to expect Congress to cut spending radically without some increases in tax revenue, Congress should give serious consideration to a broad-based national consumption tax phased in over several years. A national consumption tax would raise more revenue than an income or corporate tax increase of the same magnitude, since it taps the "underground" economy of income that is spent but unreported. Econometric simulations demonstrate that the risks of slower growth associated with a consumption tax are considerably less than with other forms of taxes. A consumption tax would decrease demand for imports, thereby raising GNP through the channel of net exports. In this respect, much of the problem of chronic trade deficits has been attributable to excessive consumption in the United States; a consumption tax would therefore improve this country's international competitive position. At the same time, a national consumption tax would redistribute the mix of GNP from consumption to saving, thereby raising liquidity, diminishing external indebtedness, and lowering interest rates.

Mr. Chairman, we do face a financial crisis of significant magnitude. At the same time, the underlying economy has shown significant elements of strength that can serve as the basis for avoiding a major economic downturn. This requires a series of policy steps that focus primarily on a reduction in our budget deficit and international indebtedness.

Senator **Sarbanes**. Thank you very much.

Mr. Hormats, please proceed.

STATEMENT OF ROBERT HORMATS, VICE PRESIDENT, GOLDMAN SACHS & CO.

Mr. **Hormats**. Thank you, Mr. Chairman. First, I want to apologize to you and the committee. Due to a number of other, shall we say, diversions in New York, I haven't had time to prepare a prepared statement.

Let me just summarize my thoughts on the subject at hand, which is, first, why we're not seeing more progress in dealing with the trade imbalance; and second, let me address some of the points that Jerry Jasinowski has so very well touched on, how to deal with the current problem.

I think it's fair to say that if one could look at the nature of the markets' concerns today and indeed look at the nature of the underlying problems facing the American economy, they come down to a basic fact. That is, you can't continue to build prosperity on growing domestic and foreign debt.

It is the recognition by investors that this was simply not a sustainable process that I think led to the sort of underlying concerns that we've seen, the general view being that as the trade deficit has not improved very much and the current account deficit has not improved very much, leading to the prospect of continued buildup in American debt, there was a general feeling in the minds of investors that the way that this was going to be resolved was a market loss of confidence in the dollar, pushing the dollar down, pushing up inflation in the United States, causing the Fed to have to raise interest rates, and therefore leading to a situation of higher domestic price pressures and lower domestic growth.

I think it is that combination of concerns and apprehensions about the future that have caused concern in not just the stock market but among people who, as you know, Mr. Chairman, testified at the last set of hearings you had on this, because these were the sort of general underlying concerns that people expressed and, in effect, the investors have caught up with this and these sort of apprehensions are very real in the minds of people who have to make choices every day as to where to put their money.

Why hasn't the trade deficit and the current account deficit improved very much? There are a lot of answers to this and I don't want to go into them in great detail, but let me just touch on a few of the aspects of the problem.

First is that the dollar's decline works in the following way. First, it creates price effects which is higher price for imports and a lower price abroad in foreign currency of American exports. Then, that translates into new orders. That translates into new shipments and that ultimately translates into volume improvements.

Well, in fact, we've seen some progress on volume improvements, but really not enough to make as much of a dent in the U.S. trade outlook as people indeed had hoped and expected.

Now the volume improvements really haven't occurred for a variety of reasons. First, you get the fact that a lot of currencies, as

Jerry Jasinowski has indicated, have really not appreciated very much vis-a-vis the dollar. A few of the major currencies have, but many haven't.

Second, even where currencies have appreciated, there has been an enormous resilience in the domestic productive capacity in the countries who experienced an appreciation of their currencies. The Japanese have a very resilient economy and a lot of their industries have adapted very well to a higher yen. They have improved their productivity. They have passed on the price effects down the supplier line so that no one company has had to absorb all the impact. And the learning curve benefits of a lot of production in the last 5 years have meant the Japanese have been able to reduce costs quite impressively, quite dramatically, in a number of sectors.

Third, the American market is unlike any other market in the world. It's very big and everyone wants a market share here. And they are willing in many cases to absorb the profit loss resulting from the lower dollar in order to retain American market share. In many cases, they built up distribution systems, they built up consumer loyalty, quality identification, and that is helping them to maintain this market share even with the yen and the mark and other currencies being stronger.

In addition, many of them made very large profits during the period of time when the dollar was very high and those profits have been sort of a buffer to them when they have had to compete with the lower dollar.

Then you've got some structural changes. One, you have a lot of countries today that are producing more agricultural goods than they were 5 or 6 years ago. You get big technological surges in Korea, Taiwan, and other places and, in effect, when the Japanese lose market share in some sectors, those newly competitive countries begin to take part of that market share.

Then you've got the whole problem of Latin American debt. Latin America was a very big market for American exports. It simply can't buy as much any more because it's constrained by debt.

So you get a whole range of reasons why the dollar has simply done the job and probably there are a few others and we can go into those a bit later. But suffice it to say, we've seen progress on volume, not as much as we would like, but we have seen some progress.

The difficulty here is that some of the progress on volume has been offset by the weaker dollar. Now the dollar has stabilized over the last several months. In fact, it's been relatively stable since February. If you take February to now, the exchange rates are not dramatically different, but in effect the lower dollar has created a sort of J-curve effect which means that the price benefits of the volume improvement have not been realized because import prices are higher than they were as a result of this. Now this at some point will work itself out, but it takes time.

The consequence of all this I think is that the debt continues to build up at a very rapid rate and every month you see bad trade statistics that convinces people in the market that the dollar is going to have to go down more.

Now let me address the problem of the dollar because I think *there's been so much discussion* of this and much of it has taken on a rather almost religious aura. There is nothing sacred about the exchange rates agreed to in the Louvre accord and there are many people who say, "The answer to this problem is simply stabilize the dollar." Well, I think all of us would accept the notion that at some point a stable dollar is better than a volatile dollar. It sounds better. In many cases, it is. But it's stability at the right level.

The problem here is that every time the market senses or people sense that maybe the dollar is going to go down a little bit more, they become worried about more inflation here and other countries become worried about the adverse effects of the dollar on their exports. So you've got problems in both markets as a result of this apprehension.

Let me discuss this for a moment. First of all, it is in my judgment unrealistic to assume that the dollar should stay at the same nominal exchange rate or the Louvre band should stay where it is, if the American rate of inflation is higher than the rates of inflation in Germany and Japan.

The notion is not to try to keep the dollar at the same nominal rate forever, because if there are inflation differentials that implies a real decline in American competitiveness. The objective should be, if there is an objective, to try to keep the dollar relatively stable in real terms and that means that, if only because of inflation rate differentials, one has to expect some decline in the dollar. If you add to that the fact that the trade balance is not improving very much, it's highly unreasonable to expect that the dollar is going to stay where it is forever.

In fact, the United States is better able today to absorb the upward cost and price pressures of a decline of the dollar than it was 3 or 4 weeks ago because, as Jerry Jasinowski pointed out, the concern now is about an economic slowdown and the upward price effects of a decline of the dollar are not as troublesome as they might have been several weeks ago.

On the other side of the coin, other countries simply have to accept the notion that their trade imbalance with the United States or their trade surplus with the United States have to decline and there is no easy way out. If they continue to be apprehensive about this, then we are going to see a lot of instability. But what needs to happen is a generalized recognition that these large current account and trade imbalances are not sustainable and other countries, if their currencies do appreciate, simply have to take action to expand their domestic economies to offset that. The answer is not to try to preserve unrealistic rates. It's to try to recognize that rates cannot remain the same unless there is improvement in trade balances. They certainly can't remain the same if there are significant inflation differentials.

So I think that one of the great concerns is that people tend to panic when they see the dollar going down a few points. In fact, it is a part, a reasonable, rational, normal part of the adjustment process and for markets to get concerned I think is not a rational response.

Let me make a couple of other points on the question of the budget deficit because I think the budget deficit has taken on a certain symbolism and a certain important economic significance as well.

The great difficulty here is that we missed excellent opportunities to deal with the budget deficit when we had relatively high rates of growth. That was the time when we could have absorbed big spending cuts and a tax increase of some magnitude without very much disruption of the economy. I think history is going to record that one major mistake was made when in 1985 the Senate Republican leadership very constructively proposed to the President an idea for dealing with the budget deficit which was rejected, and that I think meant that the debate—we lost a year in that debate.

So I find that it in a way puzzling that we didn't deal with the budget deficit when we should have. Now the problem is that the same type of solution for dealing with the problem then may not be exactly what we need today. I think Jerry Jasinowski is right, the fundamental emphasis should be on spending cuts rather than tax increases because in an environment where you're concerned about a slowdown in the economy, it is unwise to raise taxes.

Now I accept the fact that in order to reach a deal to cut the budget deficit there may need to be some tax increases, but I do hope, as Jerry Jasinowski does, that they are not on capital or savings because what this economy needs to do in order to improve its trade balance is to shift resources from consumption into savings and into new investment in the manufacturing sector.

Senator **Sarbanes**. To underscore your point, if I could just interject, there's a story by Leonard Silk in today's New York Times headed "Perilous Economic Cures—Some Experts See Tax Increases and Cuts in Spending by U.S. as Spurs to Recession," which I take is the question you're raising. That's related to your point that at an earlier time, when the economy was in a stronger position, an effort was made in the Congress to address the deficit in a more definitive way, but that was a lost opportunity.

Mr. **Hormats**. A lost opportunity, and what was good then may not be in the same form good today.

We do need a cut in the budget deficit. I think that one of the problems that confuses people is what the $23 billion is a cut from. Is it a cut from some mythical base which leaves you in the next fiscal year with, in effect, a higher budget deficit than we would have in 1987? That is to say, if you interpret the base as a very high base and you take $23 billion off of that, it could leave you with an even higher budget deficit than we will have in this fiscal year.

So we need to look at what ends up to be the budget deficit and the $23 billion figure could be very significant if the base is low. If the base is very high, it could leave you with a number that's in fact higher than fiscal year 1987.

But I do think the market is looking for some significant improvement in the budget deficit.

Now the other side of that is, in order to avoid a major contraction as a result of that, we need, as Jerry Jasinowski has pointed out, to have an expansionary monetary policy. And the Fed, in my judgment, is doing what it needs to do to expand the credit creation in this country.

The problem here is, that links to the international side of the picture because while we certainly need monetary expansion in order to offset the contractions resulting from the decline in wealth as a result of the fall in the stock market and whatever budget deficit reduction takes place, we need to offset that contraction with some action on the monetary side. The problem is that we are constrained by the fact that we need to import huge amounts—over 140 billion dollars' worth of capital, and if the interest rates in this country get too low relative to interest rates abroad, then we could see the dollar go down not by a small amount, which I think is needed, but we could lose control.

That's where the Louvre process comes in because it is extremely important, in my judgment, to keep that Louvre cooperation going, and that means central banks have to work very carefully to have interest rate differentials which are enough to have a controlled decline in the dollar to improve our competitiveness and to offset the inflation differentials, but not so much of a decline as to cause apprehensions in the markets. That means you have to have a certain amount of fine tuning among the major central banks of the world.

They also have to expand because they have contractions in their economies because their stock markets have gone down, too. So it was never more important than it is today to have the central banks working together to figure out how to get their money creation and their interest rate policies basically in harmony with one another.

I have probably gone over my time and I will leave it there, but it seems to me, just to conclude, that we have learned a lot I think from 1929, and this situation is not today 1929, but there are certain parallels and there are certain things we can do to avoid its becoming a 1929.

The three big mistakes of 1929 were, first, a resort by all countries to protectionism; second, monetary constraints, tightening in many cases, the United States included, in monetary policy; and third, tax increases.

It seems to me that the Fed is doing what it needs to do to expand credit creation and that's good and a difference from the way we responded in 1929. In 1929, we raised taxes. We raised them again and again, and that proved to be counterproductive, as we now know. And protectionism was disaster for all of us.

I think that if we do what's sound, we can avoid a lot of the apprehensions in the market that it is a 1929, but it requires leadership and it requires a comprehensive set of measures. I would just say that I very much find Jerry Jasinowski's views and mine very much consistent with the judgment that you want to approach this in a way that avoids contractionary pressures in the economy and avoids penalizing savings and investment. Thank you.

Senator **Sarbanes**. Mr. Krugman, please proceed.

STATEMENT OF PAUL KRUGMAN, INTERNATIONAL ECONOMIST, NATIONAL BUREAU OF ECONOMIC RESEARCH, AND PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. KRUGMAN. Thank you, Mr. Chairman.

I'm going to differ with my two colleagues to my left.

Senator SARBANES. That's why we have these panels.

Mr. KRUGMAN. I think the important thing to realize is that now is the time for us to break out of the Louvre accord, which is attempting to stabilize exchange rates at or near their current level. What we need right now, as soon as we can nerve ourselves up to it, is further considerable fall in the dollar.

Trying to stabilize the dollar at its current rate is exactly the wrong thing for us to be doing right now.

I am deeply concerned about the drift in the policy community toward the view that exchange rates should be stabilized somewhere near their current level. I think that's a perverse reaction both to developments in the trade and the financial area and I'd like to explain why I think that's a perverse reaction and in fact we should be doing just about the opposite.

First of all, there's been a mood developing that says, since decline in the dollar so far hasn't generated the results we hoped for on the trade balance, maybe we should stop relying on that mechanism. That's a little bit like saying that because you found out that the brakes on your automobile are not as good as you thought, you should take your foot off the brake pedal.

A decline in the dollar is the only reliable mechanism we have for turning trade around. What we are learning from the poor trade experience is that the dollar was more overvalued than we realized and that it still needs to fall further in order to achieve the turnaround in trade that we need.

Mention has been made by you, Mr. Chairman, and several others about the failure of the trade balance to show the improvement that was forecast. It should be noted that although there is some surprise, in fact all of those who have been doing real forecasts based upon models, as opposed to essentially political documents that produce a forecast consistent with other parts of a program, have been telling us all along that the widely discussed expectations of a rapid improvement in the U.S. trade balance based upon the dollar decline so far were wrong.

I'd like to draw your attention to two charts at the back of my prepared statement. The first of those charts shows the actual U.S. trade balance in manufactures and it shows results of a forecast that I've done, which is not very different from other people's, of what we should have expected based on the historical relationships between the exchange rates, national income and so forth, and the trade balance in manufactures based on data up to the end of 1984.

What we see is that, indeed, those expected trade balance numbers look a little better than what we've actually seen, but the main point really should be that we shouldn't have expected a great deal of improvement. The surprise component of the trade deficit and its persistence is actually rather small compared with the expected component.

Now how can it be that we are being told that forecasts were made of rapid improvement in the trade balance? Well, these were largely political forecasts. One point that may not be well known is that the U.S. Government, the administration, has virtually stripped itself of any trade modeling capacity. To my knowledge, the only people actually doing econometric analyses of the trade balance in the U.S. Government, broadly defined, or the administration broadly defined, are three economists at the Federal Reserve. I believe that that's it and I think that's an outrage, given the current situation.

Those three economists, incidentally, have been consistently pessimistic. They have consistently been turning out warnings that the trade balance was not going to improve rapidly, that the dollar had not fallen enough, and that it needs to fall a good deal further.

Now there is a question you may ask, which is why, since the dollar has by most measures fallen all the way back to where it started, why isn't that enough?

Some of the reasons have been alluded to by my colleagues, by Bob Hormats in particular. We know that the Latin American debt crisis has depressed demand for U.S. exports. We know that the failure of some foreign economies, particularly the European economies, to recover fully from the recession of the early 1980's depresses demand for U.S. exports.

It's also the case that historically—by which I mean the 1960's and 1970's—the United States has consistently needed to have a falling dollar over time to hold its own in international trade. The main reason for that is probably the gradual erosion, which doesn't look so gradual any more, of the one-time dominant U.S. position in technology, the one-time leadership in quality in products, and all the stories that we hear about competitiveness do have their macroeconomic reflection, their financial reflections, which is that the dollar needs to fall on trend over time unless we do something about those in order to balance our trade.

The second chart attached to the prepared statement which shows the actual U.S. real exchange rate, one measure of it, and an estimate based on my own work of that downward trend in the dollar over time, tells you what the story is.

The first half of the 1980's was, of course, marked by an enormous rise in the dollar but that was not the full story. What you actually have was a scissors effect. The dollar rose when it should have been falling. During the period from 1973 to 1980 when the United States more or less held its own, ran current account balance on average, the dollar was declining an average of about 3 percent a year. This picture simply shows what it implies if you extrapolate that trend out, which is that, although we are back where we started, we aren't back to that trend line we were following during the 1970's. We are still a fairly substantial way above where we need to get.

So the view that says that the dollar has fallen enough because it's back where it was in 1980 is, in my view, based on these estimates and on all estimates that I've seen is incorrect.

Now let me turn to the relationship between the budget deficit and the trade problem. Of course, we need to bring the budget deficit down I would say as rapidly as possible. I'm able to say that safely because I don't expect it's going to happen too rapidly. I don't think the possibility is that it will happen so fast that I would be concerned.

There is a misconception that is quite widespread that bringing down the budget deficit is somehow an alternative to a decline in the dollar. That's incorrect. Bringing down the budget deficit is a necessary accompaniment to a decline in the dollar and vice versa.

If we bring down the budget deficit, whether through spending cuts or tax increases, without doing something about the dollar, without making U.S. industry competitive, the result will be a recession in the United States. We will have a reduction in consumption demand from the Government and from the private sector and there will be nothing to take its place.

What we need to do in order to achieve this smoothly without a recession or without a too bad a recession is to have a kind of revolving door in which the decline in domestic demand is replaced by an improvement in our net exports, in exports minus imports.

Now there are many commmentators who have argued that we ought to get that improvement in net exports not through a decline in the dollar but through growth in foreign economies, which will increase the demand for our exports.

The principle is right, but the arithmetic is wrong. There's just not too much that can be expected from that source, although we should get what we can.

The point is really that expenditure in every country has a very strong domestic bias. More than 90 cents of every dollar spent in the United States is spent on goods produced here, even now, whereas only 2 or 3 percent of a dollar spent in Japan is spent on goods produced in the United States.

If foreign economies increase their demand only a quite small fraction of that increase in demand will fall on U.S. goods unless something is done to simultaneously make those U.S. goods more attractive. A rough estimate would be that it would take $8 of spending increase abroad to offset the negative impact on the U.S. economy of $1 of spending decrease in the United States.

That would mean that if we were trying to deal with our trade deficit simply by having us cut our spending and have the rest of the world increase their spending—let's say we cut our spending by $150 billion—in order for us to avoid a recession while keeping the dollar unchanged, we would have to have a $1.2 trillion increase in spending in the rest of the world. Well, that's not going to happen. It's not going to happen as a political matter and it's not going to happen because most of that increase in spending abroad would fall on their own goods and the rest of the world just doesn't have enough excess capacity to absorb that kind of increase in spending. So we are not going to be able to get more than a fairly small fraction of the trade balance improvement we need through growth in the rest of the world.

Still, you might say, shouldn't we wait? Since I've said that we need a reduction in the budget deficit and a fall in the dollar together, shouldn't we wait until we've got the deficit reduction in hand before we bring the dollar down further?

The answer is no. We need the dollar down first and we need it down for two reasons, one of which is economic and one of which is political.

The economic reason is that it takes a long time for the exchange rates to be reflected in trade. We've seen that in the past 2½ years. If we got the dollar down now, tomorrow, then we would not expect to see a strong favorable impact on U.S. trade before some time in the middle of 1989. So even if we think that no serious deficit reduction is going to occur until the next administration, now is the time to get the dollar down in anticipation of that deficit reduction.

It's also the case that if we don't have strongly improving trade at the time that serious deficit reduction measures are on the table, then I worry whether we will have the political will to do that. When the time comes to raise taxes and cut spending, you, Mr. Chairman, and everyone will see very clearly the immediate recessionary impact.

What we need to do is get the dollar down to produce the stronger trade recovery that will once again create the kind of political window of opportunity that Bob Hormats correctly says we missed in 1985.

Finally, let me turn to the relationship between the stock market and the financial turmoil and the issue of the dollar.

There are two points to notice here. The first is that the decline in the stock markets tips the balance of risk even further in favor of an immediate decline in the dollar. The reason is that the main risk in getting the dollar down is the fear that we will get all that trade balance improvement and that we don't actually bring down the budget deficit, that we'll get this increase in net export demand and we won't be prepared to cut our domestic demand to make room for and, therefore, will be headed for an inflationary overheating of the U.S. economy. That's a risk I think somebody has to take. We don't want to get into a situation in which Congress waits for the Fed to move first and the Fed waits for Congress to move first and meanwhile the continuing growth of U.S. debt goes on.

But the risks of a dollar fall leading to an overheating of the U.S. economy are now substantially reduced because some of the steam has been taken out of demand by the 37 percent fall in the stock market. So we are in a position now to be bolder in seeking the kind of trade balance improvement through dollar depreciation that the economy needs.

What about the argument that dollar decline is bad for financial markets, that it causes crises of expectation? Well, I think the lesson we should take is that if you're trying to support the dollar above the level that everybody really knows it has to fall, then any news that suggests that the game may be up soon is something that's going to make financial markets crash.

The real problem I think was not that people were afraid of what the economy would look like after the dollar has fallen. The real point was that if you think the dollar is going to fall next week, you want to get out of dollars now. There's a very fundamental distinction between an asset whose price is falling—i-n-g—and an asset whose price has fallen—e-n. An asset whose price is falling is something you want to get out of. An asset whose price has fallen is a good buy. So the way to restore confidence is to get the bad part over with, get the dollar down to a level where people no longer have a one-way bet.

Right now there are two possibilities. The dollar hangs on for a while or it falls, and everything which makes you think it might fall makes you want to get out. If we get the dollar down, then maybe we get it down a little too much or we get it down to about the right level, it might go up, it might stay constant, it might fall, there won't be that one-way option that makes us so vulnerable to speculative attack every time we have a little bit of bad trade news or every time the Secretary of the Treasury slips and tells the truth.

So I think it's very important that we get the dollar down. Of course, it's in the nature of the situation where we are trying to sustain the dollar above the level to which it has to fall that our government officials cannot in fact tell the truth. That is, as everyone who knows about the experience of fixed exchange rates knows, you always insist there will be no devaluation until the Sunday evening that you actually do it. That makes rational discussion very difficult and I think it's the job of us who do not have responsible positions in the Treasury or the Federal Reserve to say openly what our policymakers can't say even if they believe it, which is that we need to get the dollar down now. Thank you.

[The prepared statement of Mr. Krugman, together with attached charts, follows:]

PREPARED STATEMENT OF PAUL KRUGMAN

The Dollar and the Trade Deficit*

The continuing bad news on the US trade deficit has finally caught up with the stock market. However, the response being urged by much of the financial community to the collapse of the bull market is exactly the wrong one. We are now hearing urgent calls for an agreement to stabilize the dollar at its current value. This is the worst course we could take. What we need now is lower interest rates and a further fall in the dollar. An attempt to stabilize the dollar at its current level will not only eventually fail, it could be the straw that breaks the international trading system's back.

It is true that the fall of the dollar so far has not produced a strong turnaround in US trade. However, this means that the dollar must go lower, not that it should be pegged at a level that still leaves the US uncompetitive. When you're trying to stop an automobile and discover that the brakes don't work as well as you thought, you don't take your foot off the brakes, you press them harder. The persistence of the US trade deficit shows that the dollar was more overvalued than we realized, and needs to fall further.

*Testimony prepared for hearings of the Joint Economic Committee, October 28, 1987

The persistence of the trade deficit

The failure of the dollar's decline to produce a corresponding decline in the trade deficit has been a major disappointment, but it should not have been entirely unexpected. Since the dollar began declining econometric modellers of trade have been warning that the turnaround in the trade deficit would be a long time coming, and that the dollar would have to fall well below its 1980 level in order to return the US to something approaching current account balance. Chart 1 illustrates this point, comparing the actual US trade deficit in manufacturing with a projection based on historical relationships between the exchange rate, other factors and trade. (The estimated relationships use data through the end of 1984). Even if past relationships had held exactly, we should have expected only a modest improvement in the trade balance by now. The repeated assertions by policymakers in the advanced countries that the dollar has now fallen enough fly in the face not only of the raw evidence of the trade numbers but of sophisticated analysis by economists both outside and inside their governments.

Incidentally, one of the little-noticed outrages of the current US position is the incredibly low priority given to systematic analysis of our trade problems. The only research group in the US government that is addressing the failure of the trade deficit to fall other than on a day-to-day basis consists of three economists at the Federal Reserve Board. They are good people, but the size of the effort is ridiculously small given the importance of the issue. It is simply crazy that key decisions about the international financial ssytem are being made by the seat of Secretary Baker's pants, without even the most basic staff work.

Why isn't the fall in the dollar to below its 1980 levels enough to restore current account balance? There are three main reasons: the effects of the Third World debt crisis; slow growth in other advanced countries, especially in Europe; and the continuing decline in US technological preeminence in the world.

The first two reasons are familiar to everyone by now. The third is less familiar, but is a key to the present situation.

Since the 1960s the US has suffered a continuous erosion of its technological leadership in the world economy. The causes for that relative decline are complex, but the effects on the US trade position are fairly clear. Twenty years ago, the US had a near-monopoly on new and advanced products; we could afford to have high labor costs in producing traditional older goods, because we could pay our way in trade by selling other countries goods they could not produce. As this advantageous position has eroded, the US has needed increasingly to compete on price. As a result, the level of the dollar needed to balance US trade has steadily declined oever time.

Chart 2 shows the actual real exchange rate of the dollar as compared with an estimate of the level that would have been needed to balance US trade in manufactures, labelled the "competitive" level. The competitive level has steadily declined, at a rate averaging three percent per year. This means that the dollar has been chasing a moving target. It was much more overvalued in early 1985 than comparisons with 1980 suggested, and it is still overvalued even though the dollar has now fallen back to where it was seven years ago.

Now we would of course like to slow or reverse the need for continuing decline of the dollar over time. Long-term measures on savings, education, R&D and so on may eventually do this. However, they will take time and are uncertain in their effect. Meanwhile, we need to get the dollar down to a level that makes us competitive now. A firm that can only sell its goods at a fairly low price should try to improve its quality and consumer acceptance, but until it can do this, it had better not try to charge its customers more than they are willing to pay. The same is true of a nation trying to pay its way in world trade.

The trade deficit and the budget deficit

Many people now understand that there is a link between the budget deficit and the trade deficit. However, one often hears the view expressed that the US should reduce its budget deficit as a way of getting the trade deficit down without a further decline in the dollar. This is a mistake. We need both a decline in the dollar and elimination of the budget deficit, and we need the dollar down first.

The reason why reducing the budget deficit isn't enough by itself is that unless accompanied by dollar decline it will lead to a recession. Reducing the budget deficit will reduce consumption by both private US residents and the US government -- in fact, a reduction in consumption and a rise in savings is the whole point of getting rid of the deficit. If consumption falls without any new source of demand to take its place, however, the result will be recession. What we need is a revolving door in which a decline in domestic demand is offset by increases in export demand and a shift in home demand from imports to domestic goods and services. That is, to avoid a recession when bringing down the budget deficit we need to have an improvement in US net exports at the same time.

Many commentators have argued that the necessary growth in US exports should come, not from dollar decline, but from growth in demand abroad. This idea is right in principle, but the arithmetic is wrong. As US consumption falls, at least 80 cents of every dollar of spending reduction will fall on US products. If the dollar does not fall at the same time, no more than 10 percent of any increase in foreign spending will fall on US exports. So for foreign growth to offset the effects of cutting the US budget deficit, foreign demand would have to grow at least eight times as much as US demand falls. This is not going to happen; it isn't going to happen as a political matter, and indeed there is just not enough capacity in the rest of the world to accommodate such a huge demand expansion. Thus the only reliable way to get the increase in net exports the US needs is through a further decline in the dollar.

Should the dollar decline before or after the budget deficit? There are two good reasons for getting the dollar down in advance, one economic, one political.

The economic argument is that the exchange rate takes a long time to turn trade around. If the dollar were to experience a further decline tomorrow, we would not see strong favorable effects on the trade balance until something like the middle of 1989. So even though no serious budget action is likely until the next Administration, we need a dollar decline now to prepare the ground.

The political argument is that we need clear evidence of an improving trade picture if we are going to have the nerve to tackle the budget deficit seriously. Otherwise Congress is likely to see all too clearly the recessionary consequences of tax increases and spending cuts, and balk at doing what it must. We need to come into the deficit reduction process with strongly recovering trade, so that it is clear that jobs lost as a result of budget cuts will be matched by jobs gained in export and import-competing industries.

Allowing the dollar to fall now is, of course, risky. If the next President and Congress do not take advantage of falling trade deficits to cut the budget deficit, the result could be a revival of inflation. However, someone has to take the risk of moving first. Otherwise we will get caught in a trap in which Congress waits for the Fed to make the first move, and the Fed waits for Congress. Meanwhile the US trade deficit will persist, our foreign debt will grow ever larger, protectionist pressures will become irresistible, and the prospects for a truly destructive crisis will grow.

The stock market and the trade deficit

Falling stock prices reinforce the case for getting the dollar down now. They also show the risks inherent in any attempt to fix the dollar at an ultimately unsustainable level.

The immediate effect of the decline in stock prices will be a decline in consumption demand -- initially from those who directly own stocks, and more gradually over time from the large number of people whose pension fund contributions will have to rise to cover the decline in funding. This decline in consumption demand will push the economy toward recession unless it is offset by a fall in interest rates, which will tend to push the dollar down unless matched by interest rate reductions outside the US. Thus the stock market drop means that the US must give up trying to maintain the dollar at its current level to offset the immediate possibility of recession.

The decline in consumption demand also reduces the risks of allowing the dollar to fall now. Because there will be less domestic demand, the chances that a reviving trade balance will lead to an inflationary overheating of the US economy are less than they were. So the stock market crash is in effect an opportunity for the Federal Reserve: it can now act more boldly to lower interest rates and drive the dollar down than it could two weeks ago.

So far, of course, the reaction has been the reverse: pressured by the financial community, and unnerved by the response to Secretary

Baker's speculation about future dollar decline, the US is moving to stabilize the dollar at its current level. This is a fundamental misjudgement of what the world, including the financial markets, needs, which is a dollar at a realistic level rather than one supported above that level.

Doesn't the reaction of the markets to the trade deficit and fears of a dollar decline show that a lower dollar is a bad thing? No: the market reaction shows that a dollar that is *expected to decline* is a bad thing. If we get the dollar down now, investors will no longer expect it to fall further, eliminating the fear of capital losses when it declines in the future.

As it now stands, the markets expect the dollar to fall eventually, but they also expect the US to try to defend the current level, with higher interest rates if necessary. They know that when bad news on trade comes in, the risks of holding dollar assets will rise, and that in order to protect the dollar the Federal Reserve will have to bribe investors to hold dollar assets with higher interest rates. As a result, disappointing trade figures or a careless moment of truthfulness on the part of the Treasury Secretary lead to expectations of higher rates, and can set in motion a stock crash. The point is that fear about what the US will do to defend the dollar, not the effect of a decline in the dollar itself, is the problem.

As long as the US tries to defend an unrealistic exchange rate, then, we are positioned for financial panic whenever bad trade news comes in. Since frank statements by government officials can also cause a run on the dollar, the government cannot even discuss the matter rationally. This is, I suppose, a reason for hope. It may be that while officials at the Federal Reserve and the Treasury continue to assure us that the dollar will be stable at its current level, they are quietly planning to give up this increasingly destructive policy. Meanwhile, the rest of us have to say openly what they cannot: the dollar needs to fall, now.

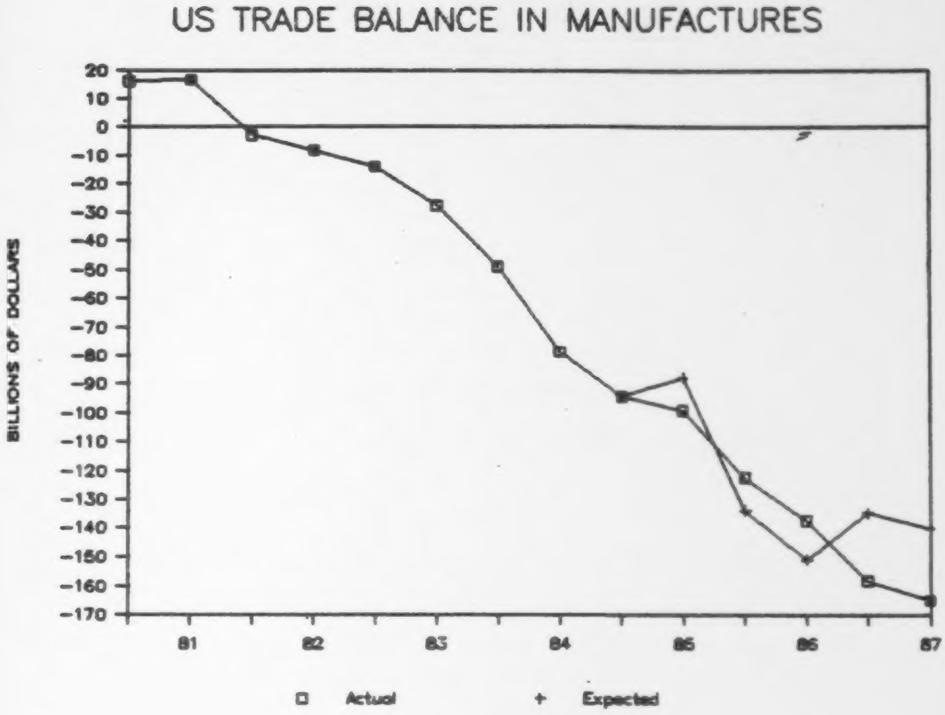
US TRADE BALANCE IN MANUFACTURES
BILLIONS OF DOLLARS
20
10
0
−10
−20
−30
−40
−50
−60
−70
−80
−90
−100
−110
−120
−130
−140
−150
−160
−170
81
82
83
84
85
86
87
□ Actual
+ Expected

Chart 1

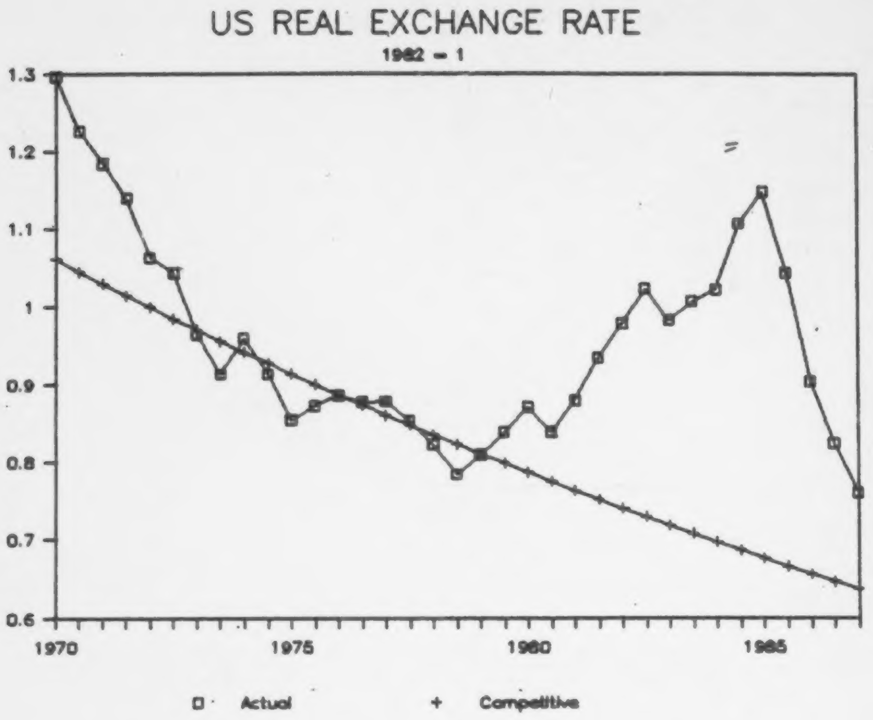
US REAL EXCHANGE RATE
1982 = 1
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
1970
1975
1980
1985
□ Actual
+ Competitive

Chart 2

Senator **Sarbanes**. Well, we thank the panel very much. I'm going to have to excuse myself and go and vote. I will come back. I will turn it over to Congressman Solarz.

Representative **Solarz** [presiding]. Thank you very much, Mr. Chairman.

It's been an extraordinarily interesting and illuminating hearing. I want to thank all of the witnesses for sharing their views on these issues with us.

Let me ask each of you if you could briefly tell us what you believe the consequences for our economy will be if we fail to significantly reduce the current trade deficit? In other words, if it remains at around $160 billion a year or even gets worse, what do you think it will mean to the economy as a whole?

Mr. **Jasinowski**. Well, I think there are two things that can happen under that circumstance, Congressman Solarz. I think obviously it will cause the current account to continue to indicate we're hemorrhaging internationally. Our indebtedness is an example of our living beyond our means. Then we will either have a very sharp decline in the dollar, 25 to 30 percent, in a very short time period along the lines of what Paul Krugman has been talking about, or I think—and it's probable both of these will occur—it is likely we will have a worldwide recession because a decline in the dollar that rapid is likely to raise interest rates and to cause enough inflation so that the economy's economic growth will be choked off.

Representative **Solarz**. Why would a decline in the dollar of that magnitude in a short period of time produce an increase in interest rates?

Mr. **Jasinowski**. Well, nobody knows precisely because we've never seen it happen, and I've always been suspicious and I would like to come back at some point and discuss Paul Krugman's point, because I do think that some decline in the dollar is necessary. I think really it's a matter of degree here and I think neither Bob Hormats nor I think that the dollar can probably stay quite where it is. But it's never happened in this country as far as I know. Maybe Bob Hormats knows of some cases. But the linkage is that it will cause a sharp increase in import prices and inflation and that in turn is going to cause interest rates to rise and the Fed is likely to intervene with tighter monetary policy to try to stabilize it, that will cause interest rates to rise also. And it is that increase in interest rates finally which causes the U.S. economy to have a recession.

It could well be, since we've never really had an exact case, that that might not happen. So I think that we are in territory where the question is very good but we don't have a historical precedent to give you. Just our own thinking.

Mr. **Hormats**. Let me just touch on that because I think Jerry Jasinowski is right. Let me just go back in history for a little bit to the last two dollar declines because we really—as Jerry Jasinowski said, we've never really seen anything quite like this—the dollar is down now roughly 30 percent against the basket of currencies from what it was in 1985. In 1972 through 1974, the dollar fell 5.5 percent. In mid-1977 through 1978, it fell 12 percent. And those were relatively modest compared to what we've experienced today.

I think the basic problem is that if the trade balance does not go down, it just creates more of the market apprehensions that Paul Krugman and Jerry Jasinowski were talking about. That is to say, if investors perceive that we are not making enough progress at current exchange rates, then the prospect is that you will not get a reasonable, steady decline of the dollar but that at some point confidence could break and it could be a much more abrupt decline and that causes——

Representative **Solarz**. In other words, you could conceivably have a kind of collapse in the value of the dollar that we witnessed in the last week in the market?

Mr. **Hormats**. We don't know. Markets are very psychological and that's why I raised the point and I think Jerry Jasinowski is right. We don't necessarily disagree with Paul Krugman that the dollar has to come down because we are not seeing enough improvement in the trade balance today. One can differ as to how much it should come down.

The real point is that governments not lose control of it. If you prop it up at an unrealistic level, at a level that the market perceives is too high, Paul Krugman is right; you simply build in expectations at some point that it will have to fall and that means two things. First, investors will stay out because they would like to buy American assets when the dollar has fallen at a cheaper rate; and, second, that they tend to demand a risk premium when they buy bonds because they say to themselves, "The dollar is going to fall and I want a little bit higher interest payment on the bonds I buy to compensate me for the risk of that dollar decline." So it is not a healthy thing for the dollar to be propped up at artificial levels.

Representative **Solarz**. Let me see if I have the syllogism correct. If the trade balance remains high, the dollar is likely to decline further, possibly very sharply. If the dollar declines sharply, then that will increase inflation because it will cost more to purchase goods, particularly from abroad. If inflation goes up, the Fed is going to increase interest rates to get inflation under control, but in the process of increasing interest rates it has a recessionary impact in the economy.

Mr. **Jasinowski**. An important point that you didn't mention and you mentioned everything else is that the sharp decline in the dollar, which is what happened in the stock market crash last week in part, is that investors will flee from dollar-denominated assets and foreign investors would do that, which in and of itself would draw out enough foreign capital to by itself, apart from inflation, raise the level of interest rates.

Mr. **Hormats**. While it's happening they would try to move out and then when it got to its bottom, whatever that bottom is, then they might come back. But we wouldn't know.

Representative **Solarz**. Well, gentlemen, you're all economists. I'm a mere humble layman, like most Americans. It's difficult for me to follow this when you rattle off these assumptions and hypotheses.

I gather that if the foreign capital that's been coming into the country, particularly to buy Treasury notes and the like, were to stop coming in, then the Fed would have to raise—interest rates would have to be raised in order to attract that capital so we could finance the operations of government. Is that correct?

Mr. **Hormats**. Yes.

Mr. **Krugman**. I'd like to—again, I don't differ totally, but let me try to answer your question first. I think your question was, what happens if we never deal with the trade deficit; and the answer to that is that can't happen. There is no such thing as forever in this business because eventually the rest of the world will stop lending us those ever-growing sums of money.

So the real question is what is wrong with doing it later rather than now? The answer is, that the later we wait, the more debt there is. The more debt there is, first of all, the bigger the swing in our trade balance has to be because we have to eventually start running a trade surplus to pay the interest on that debt and also the greater the risk of crisis in confidence in which people demand to have their debt back and we have to run even bigger trade surplus not just to pay interest but to start repaying all that debt we've accumulated.

If you want the scenario of how badly things can go, well, if the United States were to maintain its current account deficit at something like the present level relative to GNP for another 10 years, we would start to look like an enormous scale model—a larger scale model of Brazil. Then your image of what could happen to us would be that we could have an economic crisis like that which happened to Brazil and Mexico in 1982. That's the extreme version.

I think it's unlikely that things will go that far. The foreign investors are already voting with their feet and are probably just not going to finance us up to having that kind of a level of debt.

Representative **Solarz**. If you could explain in very clear terms, what is it about the current situation with respect to the trade deficit that requires this foreign financing?

Mr. **Krugman**. Well, the balance of payments always balances. The United States isn't getting any gifts from the rest of the world. If we don't sell the rest of the world as much in the way of goods as we buy from them, we must be selling them something; and what we're selling them is assets. So in a way, it's just an accounting identity. It must be the case. The only way you can run a trade deficit, unless somebody gives you foreign aid, is to be importing capital from the rest of the world, to be turning over IOU's on your future to foreigners.

Representative **Solarz**. What if you're sending some of your capital out?

Mr. **Krugman**. Well, you can sell some of the IOU's that you yourself had. We have in fact, to some extent, been selling off claims that we had on the rest of the world. We've been selling them back the factories and bonds that we had bought abroad. But one way or another, we have to sell them IOU's on ourselves.

Representative **Solarz**. Let me bring you back to the current situation, particularly here on the Hill, and I'd like to ask you a cluster of questions and ask you to briefly answer them so I get a sense of where you stand.

In terms of the effort to reach some agreement between the administration and the Congress, do you think that the deficit reduction package should be more than $23 billion? If so, by how much?

And to what extent do you think taxes should be part of the deficit reduction package and what taxes do you think or revenue enhancement, which seems to be the favorite euphemism these days, would have the least damaging impact on the economy?

Mr. JASINOWSKI. In my prepared statement, Mr. Solarz, I stress the need for a multiyear package. I think it is economically risky and politically naive to think that this can be done in 1 year. In the first year, fiscal 1988, it seems to me that the emphasis ought to be entirely on spending reductions. To the extent that taxes are brought in, it seems to me I would rely and focus on the user tax and the nonincome, noncapital taxes, because we're likely to be going into a downturn.

For the outyears, it seems to me it's a 2-to-1 ratio between spending and revenues and that we ought to look at implementing a broad-based consumption tax which would have enormous benefits on the trade front and I think that the argument that that's politically naive is yesterday's argument. I think we now have to look at our international trade position and what we've been doing in terms of consumption in this country. And if everybody would unite on that, we could deal with it.

Representative SOLARZ. Well, it seems to me, in a way, a formula which would express your thoughts would be a third, a third, a third. A third in defense spending, a third in domestic spending, and a third in taxes. That gives you your 2-to-1 ratio in spending and taxes as a way of making up the deficit reduction package.

Mr. JASINOWSKI. Well, I certainly wouldn't oppose that in terms of its first presentation. I would like to think about it further, but I think that the notion that the spending cuts must be across the board, the fact that in the outyears at least you're going to have to look at some taxes, I wouldn't find any reason to oppose that at this point. I would like to think about it a little more.

Representative SOLARZ. Mr. Hormats.

Mr. HORMATS. It's hard at this point, not being a tax expert, to know how these things will cut, but I basically think Jerry Jasinowski's approach makes a lot of sense. While one could have been more supportive—at least I could have been more supportive of a tax increase when we had a relatively high rate of growth and we weren't moving into an economic slowdown, I think that the record indicates that when you're moving into an economic slowdown you want to avoid the use of tax increases as a revenue device, both for economic and for psychological reasons because people already feel less wealthy and are less wealthy, and you're worried now about people reducing dramatically their levels of spending. You perhaps want some level of spending reduction to reduce the growth of consumption, but you don't want it to be precipitous. And the worry is, that if you did it and put too heavy an initial tax burden on, then you would get too much of a contraction in demand which you don't want.

So I would say spending cuts should be the emphasis at this point, but I also very much agree that you need a 3- or 4-year program that is credible. In the further outyears, after we've gotten over the initial wealth contraction and demand contraction effects of the stock market decline, we may be in a better position to do more of it through tax increases.

But I would also say that what we definitely need to do is boost savings and investment now and taxes that are on those elements of the economy I think would be particularly counterproductive.

Representative SOLARZ. Mr. Krugman.

Mr. KRUGMAN. There is a very simple logic that tells us about how fast we should try to reduce taxes. It's that revolving door argument. What we want to do is be cutting domestic consumption while an improvement in our trade position is coming on line, which means that the speed at which we want to bring the budget into balance is about as fast as we think trade can be turned around, which I would say would be 3 to 4 years. So it comes out to the same answer—about a 3- to 4-year phased elimination of the budget deficit.

What I would say is that is so much faster than what we're likely to get, that the gap between what makes economic sense in terms of gradualism and what makes political sense in terms of gradualism, that I would say take anything we can get as fast as we can on budget reduction.

Again, not being an expert on the budget, I don't understand where those domestic cuts are going to come from. My impression would be that there are enough sorely needed domestic expenditure increases that they are going to balance any likely cuts. So I would imagine that a higher share of the burden is going to be borne by taxes than my colleagues have been saying and, yes, the economic logic is all for a consumption tax.

Representative SOLARZ. Let me ask you finally, to what extent do you think we, in fact, have the capacity to significantly reduce the trade deficit over the next few years and to the extent we do have the capacity, what specific steps do you think we need to take in order to achieve that objective?

Mr. JASINOWSKI. Well, again, I'll start, Congressman Solarz.

I think that we have certainly the capacity to reduce the trade deficit very substantially. First of all, in net real export terms which are not irrelevant, we've seen a significant turnaround in trade already. That will begin to show itself in the nominal accounts.

Second, if you focus on further dollar devaluation—and here I'd like to emphasize that I think that it needs to focus on the nonmark, nonyen countries—Mr. Krugman's comments about further devaluations in the dollar have not really come to grips with that point and I think that there's some limits to how hard you can put this on the Japanese and German backs. But further devaluation is certainly necessary.

If we avoid a protectionist trade bill and yet implement a number of the very good reforms in the congressional trade legislation that run all the way from improving our export control system to our financing system to the foreign boycott, there's an awful lot the United States can do to promote exports—and we get the kind of cooperation with other countries in terms of their having stimulative policies, I see fairly dramatic export and import improvements possible in 1988, and that's one of the principal reasons why I am unwilling to join those who think the crash is going to necessarily push us into a recession.

Mr. **Hormats**. I think basically there is room for increases in exports. It seems to me you need a few components of the process. One that we shouldn't forget about is investment in the United States, because what we're seeing as a result of the decline in the dollar and the appreciation of some other currencies, and as a result of a general trend in business decisions abroad, is that there is a growing amount of manufacturing investment in the United States.

This does two things. It employs people and it means that goods that were sourced in Japan are now going to be sourced in California or New York or somewhere else.

So part of the adjustment process here is a shift in the allocation of production from abroad to the United States and that will help, and that's a constructive way of dealing with it because it creates new production capability and it also brings technology. That is going at a fairly substantial rate. It probably will even intensify as long as there's no big recession.

Second, we certainly need more growth in domestic demand abroad. The real key there is domestic demand. The Japanese have in fact picked up domestic demand rather significantly. In Western Europe, it's tending to lag a little bit behind the Japanese. But we need that.

Now most of these countries have a real concern about inflation and therefore we simply can't go to them and say, "Inflate your economies. Press down hard on the accelerator." Because the sort of psychology of these countries is not going to allow them to do that. But they have to do certain things just to stay even. If there is a contraction or a reduction in their net exports to the United States, just to stay even, they have to put on more stimulus to keep that reduction in exports from weakening their economy.

We still need to address the question of LDC debt because LDC debt is a very important constraint for very traditional American markets. And we also need a slowing of domestic consumption in the United States.

What has to happen here is that we have to produce more goods than we consume and what we've been doing for the last several years is consuming more goods than we produced. That means we've got to import them. And the way to deal with that shift from a high level of consumption and a relatively low level of production is to in effect channel more of the resources in the economy into the productive sector of the system, particularly into industry. That means two things. It means that we can meet a reasonable, although not as high level, of domestic consumption along with increased exports without inflationary pressures. If we don't invest and we don't reduce consumption to a degree, then meeting our trade improvement objectives will cause big price pressures.

Mr. **Krugman**. There's nothing structural that prevents the United States from turning our current account position around. We had a current account surplus and a surplus in trade in manufactured goods as recently as 1981. It wasn't some deep, underlying failure of the U.S. economy that makes us unable to balance our trade. It happened quite suddenly and it happened for the most part because of the policies that the United States has followed since then.

We do need a lower dollar to do that, but if we had a lower dollar and some growth in domestic demand abroad to compensate for the effects of that on their own economies, then we would be able to turn it around and I think there's no reason why 3 or 4 years from now we should not be able to be in current account balance.

I just want to respond to two things that have come up that I haven't commented on. One of them is the question of whether we should be focusing on the mark and the yen.

I think it is fair to say that there are some other countries that we should be concerned about, most particularly Taiwan, which is way out of line by almost any measure, incredibly out of line. Korea is a less clear case, so we shouldn't lump them all together.

But I think it's a mistake to just look at the share of our trade with Germany and Japan and conclude that it's a relatively minor part of the problem.

Two points. First, I think we should think of all of Western Europe as a mark area for practical purposes. The mark sets the exchange rate for the U.S. dollar vis-a-vis all of Western Europe, and that includes Britain, which isn't even part of the EMS, but nonetheless, for all practical purposes, Western Europe is a mark area. And that greatly enlarges the importance of the mark.

Second, what you really expect is not the countries that we trade with should change their exchange rates. It's that deficit countries should depreciate and surplus countries should appreciate. Who are the big surplus countries? Germany, Japan, and Taiwan are actually the big surplus countries in the world right now. Canada, although it's our major trading partner, is not a surplus country. Therefore, we shouldn't be expecting the Canadian dollar to bear the brunt of the necessary depreciation of the U.S. dollar. That's just not reasonable.

The second issue I want to deal with is the argument that both my colleagues have made, which is that we need a gradual decline in the dollar. In effect, I think they are conceding the point that the dollar does need to come down a good deal further, but they're saying let's do it sensibly and gradually.

That sounds sensible. It isn't. That's not the way financial markets work. Suppose that what seems to be a reasonable number—the dollar needs to come down another 20 percent, and suppose we say we're going to do that gradually. We're going to work it down over 3 years. And suppose we tell the world that. We tell the international investors we're going to work the dollar down by 20 percent over 3 years.

Well, that's an assured 7-percent decline in the dollar each year. And if I were an international investor, I would be getting the hell out of dollars while it was happening, unless the United States offered me an interest rate which is 7 percentage points above the interest rates in Japan and Germany, which is presumably not what we're planning to do.

So I don't think there's any way to honestly—that is, telling the truth—manage a gradual decline in the dollar. If we think it has to come down and we say so, then it's going to come down most of the way right away.

What has happened over the past 2 years has been a sort of gradual decline precisely because of the fog that has surrounded policy intentions and I hope we aren't proposing that the United States should set a deliberate policy of creating enough fog and smoke around our exchange rate policy that we can work the dollar down by 20 percent over 3 years without telling anybody. I don't think that's going to work.

Mr. HORMATS. May I comment?

Senator SARBANES [presiding]. Just very briefly.

Mr. HORMATS. There is an argument to be made that I keep hearing that you should just let the dollar go on, but I would say to you the way financial markets work—first of all, we don't know what the right rate is. We simply don't know.

Let me go back a few years. In 1985, people said, "If only the dollar were to go to 200 yen, all would be well." A lot of economists said this. That was wrong. We don't know. And if we try to make ourselves into sort of demigods and say the right rate is x, we simply don't know what it is, and that's not going to have any credibility to anyone in the market, if some economists set the right rate or try to set the right rate or even imply that they can.

The second point is this. If you give the notion——

Senator SARBANES. Does the same logic apply when you're trying to hold it at a given rate, as opposed to trying to take it to a lower rate?

Mr. HORMATS. Yes.

Mr. KRUGMAN. I find it puzzling to argue that you can't try to set the right rates so therefore you should try to set the wrong rate.

Mr. HORMATS. No. I'm agreeing with the point that most people would accept the fact that this is probably an artificially strong dollar. But having said that doesn't mean I could tell you today what the right rate was. I simply don't know the answer to that.

I would go on to say, if you imply the notion that you want the dollar to come down precipitously, you will then really lose control of this. We've seen markets that are very volatile and I think there's a great danger in trying to play God with the currency. We simply don't know what the right rate is and if governments lose control of currencies and the currency really starts plummeting, we simply don't know where it's going to end up any more than we know where the stock market is going to end up.

So markets don't work the way the minds of economists work. Markets work——

Senator SARBANES. Very few things do.

Mr. HORMATS. Right.

Senator SARBANES. As we both know.

Mr. HORMATS. That's right. But the problem is, you're liable to end up with something that we have no control over. So I think allowing this thing to sort of gyrate and find some mythical level that a few economists agree to is not going to have very much impact of a positive nature either.

Senator SARBANES. Congressman McMillan.

Representative MCMILLAN. Thank you, Mr. Chairman.

Let me get back to a couple of points on the trade issue that Mr. Krugman made. You indicated that if the dollar went through an adjustment that would get it into its appropriate balance rather immediately, the effect might not be felt until mid-1989. Is that correct?

Mr. KRUGMAN. That most of them would not be felt.

Representative MCMILLAN. If that's the case and we have in fact experienced a 30-percent decline in the dollar over whatever recent period of time has occurred, then we really haven't, according to that approach, felt the full impact of that 30 percent decline. Is that true?

Mr. KRUGMAN. That's correct.

Representative MCMILLAN. If that's the case, then how much improvement in the trade deficit is implicit in that 30-percent decline that we might expect if we did nothing?

Mr. KRUGMAN. Most estimates that I and other people have made suggest that in the pipeline at current exchange rates are improvements that will bring the trade deficit down significantly, but will still leave it at a triple digit number, at its bottom. So that, yes, we have a significant improvement coming, although we've been saying that for a couple of quarters now and it hasn't actually shown up, but if we believe the best estimates we can make on the basis of history, we should be seeing a significant but not sufficient improvement still in the pipeline from the dollar decline so far.

Representative MCMILLAN. One other point that I think there appears to be some disagreement among you on: I think it makes good sense for us to encourage our major trading partners, particularly the Japanese and the Germans, to accelerate the level of growth within their own countries. But the point was made that this would have only marginal impact upon the United States because of the relatively small proportion of U.S. imports in those countries.

I think there's another factor which I would like you to comment on, and that is, if they increase domestic consumption in their own economies, then there's less pressure to maintain output to export that output into the world markets and particularly the United States. So that this layman thinks that it might tend to have a far greater effect at this marginal level than what the overall relative importance of U.S. imports into those economies would indicate.

Mr. JASINOWSKI. I would think that that's a very good point, Congressman, if I could answer, and I say it from the perspective of just having visited Japan and got a sense of the extent to which domestic demand is repressed there. If you tie that to some of the trade restrictions that occur in Japan, it's very easy to see a change in increased domestic consumption which they are beginning to do, as Bob Hormats said, could have an effect on the old ratios of consumption of foreign goods versus American goods. And if there's a further breakthrough with respect to some of the restrictions, I think you could see a substantial progress with respect to increased U.S. exports being consumed by other countries as long as world growth is maintained at reasonable levels.

Mr. HORMATS. I think that's right. Let's suppose they import, just for the sake of argument, 5 percent of their imports from the United States. Let's take Japan—between 5 and 10 let's say. If they grow more, they are also importing more copper from Latin America, more coffee from Indonesia, and these countries then have more buying power to purchase American goods. As a result of that, particularly with the new exchange rate relationships, we should be more competitive in selling to them than some other countries because we're more competitively priced because the dollar has declined.

Also, they need to shift the focus of their exporting somewhat away from the American market, which has really taken the big increases in manufactured exports from the Third World over the last several years, and move them more into Western Europe and Japan, and more growth in those economies would do it.

So we get a bilateral benefit, but it may well be that that triangular benefit that we get through increased third country capacity to import is just as helpful in some cases.

Mr. **Krugman**. Again, let me say that the direction is right but the arithmetic isn't right.

The rest of the world, just take it as a bloc, so we take into account all of these linkages between other foreign countries, spends probably only about 3 percent of its total spending on goods made in the United States. It is true that when demand in a country expands that usually has a more than proportional effect on the trade balance and more of an increase of spending falls on imports than of the average spending so far. If I increase my spending by a hundred dollars, even if I'm only spending 3 percent of my current income on imports, I might spend 6 or 7 percent of the increase on imports, there is some possible diversion of exports back to the home markets, some reduction in pressure to export.

Those effects are factored into all the calculations I've been talking about, the pessimistic results from the trade modelers.

Even if we grant a huge difference between the marginal effect of a change in spending and the average level of imports in the rest of the world, then the rest of the world would reduce its trade surplus with the United States by only 10 cents for every dollar of spending. They really only spend currently 3 cents of each dollar on U.S. goods. Even if we give very strong effects of the kind that you're discussing, Congressman, it would have a fairly minor effect on the U.S. trade balance.

Representative **McMillan**. Well, let me probe that from one additional angle. My figures probably won't be exact and you can correct me if they're not, but the sectoral composition of the U.S. trade deficit is attributable to three and possibly four major areas—automobiles, oil, plus steel and textiles. This constitutes, in the aggregate, more than two-thirds of the trade deficit. Is that right?

Mr. **Krugman**. I don't have the numbers in front of me, but I would not be surprised if that were true.

Representative **McMillan**. I mean, those are deficits within those industries. I'm talking about the contribution of each industry to the aggregate deficit, not total imports to the deficit. Roughly, it's something like $40 or $50 billion a year on oil; automobiles are somewhat in the same proportion; steel is about $10 billion; textiles is some $13 billion.

Then on the export side, probably a major weakness has been in agriculture.

Mr. **Krugman**. Yes.

Representative McMillan. How do you factor these things into anticipating how accelerated growth in Western Europe and Japan might influence the import situation; or do we simply look at it in terms of its broad impact across the board on all imports?

Mr. Krugman. The estimates I've been citing use averages. They don't look at it in industry detail. But that's not inconsistent with having the stories about industries. I don't think that you get a very different picture if you start to break it down to the level of what happens in each individual industry.

I think it's a mistake also to simply say which are the sectors with the biggest trade deficits and say that's where our trade deficit problem is. The United States had big trade deficits in those same sectors in 1981 and yet we had a current account surplus because we were offsetting it with either minor trade deficits or trade surpluses in other sectors, and the decline since then has been across the board. If we have a recovery, the recovery will, we hope, be across the board as well, not focused only on those sectors which have our biggest deficits right now.

Mr. Jasinowski. Congressman McMillan, I'd like to agree with your view that looking at the sectors has some considerable importance here and the reason I would is because although I have long felt that the macroeconomic aspects of this problem were dominant, I do think that the microeconomic questions of costs, quality, regulations, and all the rest of these on individual industries—take agriculture, for example—are also significant. One of the biggest mistakes the Carter administration made was to put export controls on agriculture, which in turn ended up pricing us out of the agricultural market, allowing other countries to get in. They started increasing supply—a whole set of microeconomic dynamics had an enormous effect on the agricultural market.

And you can see quality and cost problems in the steel industry as a major cause of the issues there, and some of those fall back on corporate decisions. So I feel that these microeconomic factors are very crucial to our becoming more successful in international trade—not as important as the macro—and therefore, really should be focused on.

Mr. Hormats. Let me just add two thoughts. One, I think there is a lot in the debate which has been basically macro. Macro is where the big numbers are. That's quite true. But there are a lot of things that other countries have done in terms of their cost-cutting and quality improvement capabilities that have enabled them to respond in a very strong way to the appreciation of their currencies. They haven't just done this by sitting back and watching the currencies move. They have done intensive efforts to cut costs, to accommodate to or to respond to the higher currencies. So there's a lot on the macroproductivity, quality control inventory management side that is important.

The second point is getting back to the question of domestic demand. I wouldn't necessarily disagree with Paul Krugman's numbers. Paul has done them. I respect his analysis and, therefore, there's no point in arguing with it.

I would simply make a point, however. That is, if the U.S. trade deficit is to be brought into equilibrium some time in the early part of the next decade, that's going to require a net trade shift of something over $170, $180 or $200 billion—a lot of money, in the $170 to $200 billion range. That means that all of our trading partners together, if we're to come into trade equilibrium, are going to have to give up over a period of time net exports of roughly that amount.

Now they can't do that without a major contraction in their economies without some offsetting stimulus in domestic demand to compensate for that net reduction in exports, if that in fact is to happen.

So the stimulus is needed. It may not in itself lead to dramatic improvements in new imports, but it certainly is needed by them to offset the contraction which would occur from a reduction in net exports.

Representative McMILLAN. Let me just shift gears. I'm not sure we got Congressman Solarz' question answered having to do with maybe more immediate decisions we're going to have before us with respect to deficit reduction, spending and taxation.

Mr. Hormats, I think you raised the point of the confusion out there in terms of what does 23 billion dollars' worth of deficit reduction mean, from what? I'm not sure in the way the Gramm-Rudman law was structured that that's clear. I agree with you.

But the base line estimate for 1988, which is essentially a combination of existing programs with inflationary adjustments, and so forth, I think is somewhere in the neighborhood of $183 billion. So if in fact a $23 billion reduction occurred from that, we would be at roughly $160 billion deficit next year when in fact we expect the deficit this year to be perhaps some $10 billion less than that.

Now if in fact that is the right framework within which we've got to make a decision, what do you think is called for under the circumstances, with all of the things that we've discussed relative to the negative impact of increased taxes or not overdoing the spending restraint—what do you think would be the signal that would be interpreted in the marketplace as Congress comes to grips with the problem in the current year, recognizing that we've got to look at it over 3 years? We've got to look at it in terms of a plan to bring it to success over time.

Mr. HORMATS. I honestly can't give you a magic number that I could say to you with a high degree of conviction is going to be convincing in the market, whereas anything below that would not be convincing in the market. I simply don't know.

I would make a couple of observations, though. One, I do think that it is not going to look very impressive to the market if the aggregate budget deficit in fiscal 1988 is higher than fiscal 1987. The magic $23 billion number is not going to be looked at for very long if that magic $23 billion number gets you to a budget deficit level that is in fact higher in fiscal year 1988 than fiscal year 1987.

People will think that's gimmicktry because then they say, well, all you're doing is changing the base and taking $23 billion from a mythical base.

Second, it has to be credible and this is what I have found and perhaps others as well have found has been troublesome to people about some of these other budgets. They make certain assumptions and they pull numbers together and you can't really tell whether it is a real cut in government expenditures or some manufactured cut designed to comply with the Gramm-Rudman figures but really doesn't do that. I mean, it violates the spirit because the numbers are contrived. So the credibility is the second point.

And the third is that if the numbers this year for fiscal year 1988 can get you below the fiscal year 1987 and people say to themselves that there is really a new willingness and a very concrete set of measures that are going to be taken to get you to lower numbers in fiscal year 1989 and 1990, I think that would work. But it has to be very credible, very understandable, and it can't be made out of artifical assumptions. It has to be assumptions that people can say are real and actually will be put into effect.

Mr. JASINOWSKI. I concur with both the points that Bob Hormats is making and would only make a third. The number I think should be $23 to $30 billion, as I indicated, although I think, again, the magic I think is mainly in trying to do something more than $23 billion for the first year without trying to overextend yourself both in terms of its impact on the economy and what's politically doable.

I think that goes to my third point. I think it ought to be decided in the next week or so. I think the sooner that this gets settled, the better off we are. Therefore, don't try to swallow a horse. Let's get what's on the table settled with a commitment to continue the process and come back.

Therefore, I see no reason for this not to be settled within the next week and I think that's very important.

Mr. HORMATS. I agree with that. The longer you wait, the greater the level of uncertainty.

Representative MCMILLAN. I would agree with that. Do you agree, Mr. Krugman?

Mr. KRUGMAN. I would just say that it's important to get something. The numbers we're talking about are so small relative to what needs to be done that we really shouldn't be worrying about the economic impact at all. We should try to get as much as we can politically, but it's important to get something.

Representative MCMILLAN. A sensitive area is whether there should be spending restraint—I'll call it restraint because we can get significant reductions with restraint and not cuts vis-a-vis taxes. I've heard you say that some of both will probably be in a ratio of $2 of spending to $1 of revenue enhancement or new taxes, not just from growth but new sources of revenue.

You've also expressed concern—and I think we all appreciate this—that two of our major problems are excessive consumption and low savings.

We've just completed a tax reform package involving a major restructuring of tax rates which everyone is very reluctant to disturb, including me. If additional revenues have to be sought, and there is an economic objective to be achieved that benefits the economy, where do you think we should be looking in that respect?

Some of you mentioned a consumption tax. Where should that tax fall? Are you prepared to advance an opinion?

Mr. JASINOWSKI. Well, I'd like to say some more about the consumption tax because I recognize how politically difficult stepping up to that issue will be and I would only say that we have really two problems to solve. One is the international competitiveness problem which is really in the backdrop of everything we've talked about, Congressman; and the second is the budget deficit, and the two are obviously interrelated.

There is no other tax that can make as much progress on both of those fronts as a broad-based consumption tax, be it a national sales tax, be it a VAT, or whatever; and it is for that reason why I think that the rules of the game have changed somewhat with respect to the consumption tax.

Finally, if you're in a difficult economic time, you don't want to pass great big taxes on narrowly targeted sectors. You want something that we all have to share in and carry the burden of except for those who are below the poverty line or in some other sense defined, as they should be, as economically disadvantaged enough that they should not be affected by that tax. And that could be done.

But you and I and all the rest of the consumers of this country are going to have to step up to the plate at some point soon and begin to pay for all this stuff that we've been enjoying.

Representative **McMillan**. If we don't, we're going to pay for it in other ways, right?

Mr. **Jasinowski**. That's exactly right.

Representative **McMillan**. In higher interest rates.

Mr. **Jasinowski**. That's right. And I, for one—and I'm speaking now personally—would much prefer something which goes about it in that way. Furthermore, you can structure consumption taxes to be—not just as progressive as income taxes—but you can certainly prevent them from being regressive, which is the major argument against them.

Mr. **Krugman**. I would just comment that the real national problem if we try to put together the budget deficit and much of the competitiveness problem comes to a low national savings rate, whereby national savings, I mean the sum of what the private and the public sectors do. The biggest piece of that problem right now is the negative savings rate of the public sector, otherwise known as the Federal deficit.

But we also have a low and declining private sector savings rate. As best we can tell, the economic logic is clear, income taxes provide a strong disincentive to saving. Consumption taxes do not. So that gives you a good reason to look to a consumption-based tax as the way in which we're going to close the budget deficit.

Representative **McMillan**. Thank you very much.

Senator **Sarbanes**. Let me just follow up with one question on the basis of what Congressman McMillan asked, and then I'll develop the other points I have.

Would you agree that perhaps as important, or more important, than the size of the deficit reduction figure is its authenticity and its lasting nature over time, so it actually does change the trend lines?

Let me give you an example. The President submitted a budget that would pick up revenues by asset sales. Now there's some serious question whether the asset sales in and of themselves are a good thing—given the nature of the proposed sale that's involved and the particular assets involved.

Leaving that to one side, isn't there a problem because asset sales are really a one-time fix? They are not a revenue source that will be there the following year to continue to contribute toward reducing the deficit, unless of course you locate more assets to sell off. That's selling off our strengthens, as it were. Perhaps it's better not to have quite as large a figure if it is truly a solid figure that does change the trend line. Then we want to see a narrowing of the deficit year to year to year.

Mr. KRUGMAN. Mr. Chairman, selling off assets isn't even a one-time fix. What we care about is the national savings rate. What we're trying to do is diminish the drain of the Federal Government on national savings. If the Federal Government finances its deficit by selling off some of its assets as opposed to selling Treasury bills, that does nothing to help the problem, not even in the first year.

Mr. JASINOWSKI. Mr. Chairman, I agree with your view about the size being less important than the structure and the credibility and the timing. The thrust of my testimony is to argue for a multiyear program. I think in addition to all that, you know and I know and everybody else knows that we have bigger appetites for these things when there's a crisis than we in fact are going to do. So let's get on with getting a nice, decent package for fiscal 1988 soon and then move forward with the other years and the commitment to do so and to do that all as a part of the same process. Nobody ought to be left off the hook, but I think that that's the way to proceed and, as Bob Hormats has focused on, credibility in that whole process is critical.

Mr. HORMATS. I agree. I think if you can get this number this year in fiscal year 1988 down below 1987 with credible, authentic numbers, not hoped of numbers that are sometimes put into these things, and then get a credible multiyear program, an authentic multiyear program that people can see is going to happen and is based on real numbers, then I think you've got something.

Senator SARBANES. The reduction of the deficit this year ought not to be done in a way that will open up the deficit gap again the next year. It ought to be done in a way that in closing it down this year will contribute to closing it down further the next year.

Mr. HORMATS. Precisely.

Senator SARBANES. I'm a little concerned by some of this testimony of what I guess one might describe as the dismissal of marginal impacts. In other words, we talk about doing this and everyone says, "Well, that's only at the margin." Mr. Krugman, you talked about how, if they expand growth in these other economies, imports are still very small, $3 out of every $100 and so forth.

Someone else dismisses how much a lower dollar might contribute. Of course, you put great premium on that. And so forth and so on.

When we issued this report in August, we talked about a domestic economic policy to promote growth which addressed, one, the deficit question and, two, within that, set priorities in terms of investment policies—public investment policies and private—that would strengthen our competitive ability in terms of human resources, physical infrastructure, the civilian technology base.

But in the area of foreign economic policy, we said, "An economic growth strategy which places a priority on improving our external trade and net asset position will require: First, reduction of foreign trade barriers; second, achieving and maintaining appropriate exchange rates with our trading partners; third, economic policy coordination to ensure faster growth in Japan and Europe and thus increase demand for imports; and fourth, a solution to the debt crisis in the developing countries which will allow them to increase their imports and contribute toward world economic growth.

Now, in my view, no one of them can do the job alone and can't even come close to it. But if we do something in each area—which someone might want to dismiss as marginal, but isn't if you add it all up—then it amounts to a package that may well be able to make a difference.

Does anyone differ with that?

Mr. Hormats. No. I think that's right. I think while we may in this panel disagree with just how much any individual component is going to achieve, I think we would all probably conclude that there's no one answer to this. There are a lot of parts to the answer and it involves exchange rates; it involves higher growth abroad; it involves more foreign investment here; it involves dealing with Third World debt; it involves productivity increases here.

Now we may differ as to what percentage of the solution each of those is, but I think if you assume there is no one overall miracle that's going to work here, then you have to assume you have to do a lot of things and put it together into a package that's going to work.

Senator Sarbanes. Of course, the more factors you have in the package, the less stress is encountered by an overreliance on one or two factors alone. Isn't that correct? It becomes a much more acceptable package to put into place and to implement.

Mr. Jasinowski. I think that's right, Mr. Chairman, and I would agree with your view on the package and only add to it, as I have before this committee before, the view that the corporations in this great country must do as much to improve their quality, costs, technology, and aggressive marketing abroad.

We at the National Association of Manufacturers have been running seminars around the country on manufacturing excellence, put a lot of our information emphasis programs on becoming more competitive. There's been enormous progress in that area and a lot of work still to be done. So you add that in with things at the private sector, and you begin coming up with a fairly comprehensive set of points which I think is the only way to address what has been a negligence over a decade and a half.

Mr. Krugman. Mr. Chairman, the reason for emphasizing the marginality of many of these measures that should be taken is not so that they should not be taken, but we have a situation in which the finance ministers and central bankers of the world seem to be in the process of taking out what I think is the most important element of the necessary program of restoring U.S. trade balance, which is decline of the dollar to a competitive level; and, therefore, it's important in our analysis that the other measures by themselves do not add up to nearly enough to do the job without that fall in the dollar.

Senator Sarbanes. On that point, Jerry, I'd like to pursue with you the table in your prepared statement, table 1.

Mr. Jasinowski. Yes, Mr. Chairman.

Senator Sarbanes. This is your trade forecast, is that correct?

Mr. **Jasinowski**. Yes.

Senator **Sarbanes**. Now you're forecasting that between the third quarter of 1987 to the fourth quarter of 1988—in other words, from where we are now to the end of next year—our net export position is going to improve to the extent of going from a minus $134 billion to minus $66 billion?

Mr. **Jasinowski**. Well, the net export—I'm trying to be sure I've got it. Yes, I'm in the same column as you. That's exactly right, Mr. Chairman. On a net export basis in terms of 1981 dollars, we go from a negative $134 to a negative $66, quite a dramatic improvement in net exports, which of course is not the trade deficit but which is the way we measure trade flows in the national income accounts. Nevertheless, that's very dramatic improvement.

Senator **Sarbanes**. It certainly is. I mean, since we're talking about credibility and realism, what's your reaction when the question is put to you?

Mr. **Jasinowski**. Well, I think it's a fair criticism, Mr. Chairman. As I went over these numbers, I questioned them the same way you did. I said these seem awfully optimistic. I would be interested in my colleagues' observations. I have the hunch that the potential for very sharp further trade improvements, if we avoid a worldwide recession, is pretty substantial.

So one of the reasons I left the numbers as optimistic as they are is that.

The other reason I left them that optimistic is we've built in a pretty substantial dollar devaluation into this set of forecasts.

Senator **Sarbanes**. That's what I was going to ask about. I was going to go next to that column that says "Exchange rate (index)," and ask about your assumption of what was going to happen to that?

Mr. **Jasinowski**. I think it's about an 18-percent decline in the dollar and I think if you assume that the dollar continues to decline, you assume that we've already begun to make progress, these numbers tend to be fairly close to the kind of improvement in net real exports we've had over the last three quarters. So from that point of view they don't look so optimistic.

In any event, I would be interested in my colleagues' observations since I think the question you raise is a very good one—are these overly optimistic? And I might say, even if you get this improvement, you might not get the improvement on the current account and that's part of the reason I'm less optimistic for 1988 is that the nominal dollars are what tends to affect the current account, so that even though you can get—this seems very strange I know—you can get improvements on net exports that buoy American growth but you might not make the progress on the current account that you need in order to solve this international indebtedness problem.

Senator **Sarbanes**. I do want to hear from your two colleagues in response to the question you put to them. Let me just make this observation, however, that the assumptions you make on the further decline in the value of the dollar in putting together this trade forecast do not leave you all that far apart from what Professor Krugman has been talking about this morning with respect to a fall in the dollar.

Mr. JASINOWSKI. Well, I think that's right. I think the difference between Paul Krugman and I is that he's a cold shower guy while I'm a guy who likes to take a leisurely warm shower and see this kind of dollar decline occur over a couple of years under orderly conditions. Paul is willing to step in there in the morning and take it all in one quarter or something like that. That's the difference.

Mr. KRUGMAN. May I point out that if I believe this forecast—in particular, if I believe that exchange rate index, I would be buying yen as soon as I leave this room because that's a guaranteed 13 percent in the dollar over only seven quarters. That's quite a lot of capital loss if you're a Japanese holding U.S. investments and it's quite a lot of capital gain. So I don't think you can actually smoothly manage this kind of decline. I just don't think that's financially feasible.

I would also point out that the number that you would hear on the news is not the top line of this table. This forecast actually looks quite reasonable to me. I'm having some trouble of translation into slightly different numbers which I generate which are in a different format, but it looks quite reasonable to me.

But what we actually hear is not the 1982 dollar national income accounting basis net exports. What we hear is the current dollars trade balance. Notice we have a net exports in current dollars line, three lines from the bottom there. In that one, the improvement is much less marked and that's because of the rising price of imports as the exchange rate declines here. And also note that what we usually call trade deficit is a number that's a good deal bigger than this NEPA basis on net exports—I guess about $50 billion bigger.

So that if I'm not mistaken, that 1988 fourth quarter number, what looks like $66 billion there at the top, would actually be on the evening news a trade deficit still well in excess of $100 billion.

Mr. JASINOWSKI. That's correct, Mr. Chairman.

Senator SARBANES. Let me ask you this line of questioning and then I will yield to Congressman Scheuer.

Mr. Jasinowski, you say in your prepared statement, "As to why the stock market should deviate so far from the equilibrium levels implied by economic fundamentals, first on the up side and then on the down side, there has in fact been a tendency during the last few years toward an increasing disjunction between the financial sector and the real economy."

I really want to ask your colleagues whether they agree that in the last few years there has been such a tendency, or increasing disjunction between the financial sector and the real economy, and if so, why?

Mr. HORMATS. Well, the way I interpret that is that the stock market has gone up more rapidly than growth in the real economy and by all accounts that's right. In other words, there's been a higher rate of growth in the value of stocks than there has been in the growth of the goods side of the economy.

Mr. JASINOWSKI. Mr. Chairman, if I could just elaborate on the idea a little bit, it is that, but it is beyond that. In the past, there's been a very tight linkage between stock market performance and what goes on in the productive economy, primarily as earnings are affected.

What I'm suggesting—and this is sort of my pet point—is that the stock market is really now very much on its own to a much greater extent and separated from the productive economy, driven by international capital flows, driven by views of economics that aren't related to earnings, driven by mergers and acquisitions, and I think to some extent technical factors such as program trading. So that it at least before the crash got itself off somewhat from the reality of the economy more than it had historically.

Mr. KRUGMAN. I'm sure that if we take the long view that what we've experienced is any worse than speculative bubbles that have occurred over the course of history. It's certainly true that we have been seeing financial markets doing pretty bad.

Senator SARBANES. Let's limit it to the post-World War II period.

Mr. KRUGMAN. The post-World War II period has been an extraordinarily stable period and I guess we've learned that we shouldn't think of that stability and that sensibleness on the part of the market as being something that is a right. It's just something that happened.

Senator SARBANES. So, you're saying that the market was being driven, in a sense, by speculative forces that were not correlated with what was happening in the underlying real economy.

Mr. JASINOWSKI. Absolutely, Mr. Chairman. One of the reasons I'm more optimistic than a number of economists about 1988, even though I see the economy being slowed by the crash, is that I think that the down side for the economy will be less because these speculative excesses were not in manufacturing. They were not in other parts of industry. They were not in many aspects of service industries which were getting more productive, leaner and meaner, and in fact were in the third quarter showing stronger economic conditions than in the beginning of the year.

Senator SARBANES. The difficulty, though, is that if you have a real fall in the financial sector, the disjunction may end. It can have an impact on the real economy and precipitate a downturn there that is a real downturn.

Mr. JASINOWSKI. Yes, sir. That's the risk.

Mr. HORMATS. I think Jerry Jasinowski is right. If you look at the fundamental domestic aspects of the economy, the inflation rate was improving, the unemployment rate was improving, corporate profits were improving, better inventory management. What tended to disturb people enormously was these big imbalances and the implications thereof for the economy over the medium term and the fact that everybody thought that those imbalances at some point could lead to disruption in this course.

What has now happened is that you've taken a very considerable amount of wealth out of the economy. A fellow who had put, say $20,000 in the stock market now finds that that may be worth $15,000 and he says to himself, "I'm just going to consume less" And if you get millions and millions of people making a similar judgment, it could lead to a substantial decline in consumption which could weaken the economic growth outlook rather considerably.

Now the Fed is trying to do something about this by keeping the system a little more liquid than it was in the past, but there's still this risk of a big pullback in consumption.

The other part of the risk is that it's hard to raise equity today. If you're an investor and you want to raise equity with the equity markets very volatile, how do you raise new equity issues?

So you've got not only the concern on the consumption side, you've got the concern on the investment side by people who might have a particularly good project to invest in and want to raise equity for it but find it very hard to do that.

Senator SARBANES. Congressman Scheuer.

Representative SCHEUER. Mr. Hormats, it's good to see you. It's good to see all of you.

You're saying there would be deleterious effects from people deciding they're going to spend less. Yet, isn't one of the problems in our economy the fact that we're spending too much and investing too little in research and development and new plant and equipment? We're spending too much and we're borrowing from abroad to finance this binge of spending.

How do you parcel it all out?

Mr. HORMATS. Earlier, I tried to make the point that we needed to have a slowdown in the rate of growth in consumption so that we could allocate more of our national resources to saving and to investment, particularly into investment into the manufacturing sector, so we can produce the goods we need to meet domestic demand plus the additional demand we hope to get out of the decline in the dollar and any additional growth that might occur abroad.

The question occurs that you want to slow domestic demand and domestic consumption.

Representative SCHEUER. You want to slow the rate of growth.

Mr. HORMATS. The rate of growth of domestic demand.

Representative SCHEUER. You don't want to slow——

Mr. HORMATS. I don't want to bring it to a crashing halt. That's the difference. And I think it's very hard. And it's partly economic and it's partly psychological. If you think you're not well off or as well off as you were, and you see your savings drop a little bit, you say to yourself, "Instead of buying my kid a bike and a little computer for Christmas, I'm just going to buy the computer and not buy the bike." It leads to an economic pullback and sort of a psychological pullback and we simply don't know what the magnitude of that will be.

While we want to see a slowing in the growth in consumption and we need it for all sorts of reasons of reallocating resources, we don't want to bring it to a wrenching halt.

Representative SCHEUER. Let me ask sort of a broad question. There has been a lot of Japan bashing in the debate over the trade bill you're all familiar with. We are very much concerned with access to markets in Japan and Taiwan. Here's Taiwan sitting, I'm informed, with the largest volume of foreign currency reserves in the world. We've seen the instantaneous, almost violent reaction of the securities markets, the exchanges, in Hong Kong and Tokyo.

What does the current minicrisis in the securities market and what does the current drive to reduce the budget deficit and, hopefully, the trade deficit mean to our relations with our Pacific Rim neighbors who now constitute by far our biggest economic trading area? How can we react in a constructive way, hopefully, to the problems and also the opportunities that we're facing in Asia?

Mr. **Jasinowski**. Well, I think that's a very good question, Congressman, because the Japanese have not been—they have been unhelpful in some respects, but they have been remarkably willing to suffer some exchange reevaluations which have not been easy on their economy. And I think that shows some commitment on their part to try to deal with this problem.

One of the reasons I'm reluctant to push the Japanese further on the exchange rate is for that reason. So I would be inclined to not put my primary emphasis on the yen in terms of further dollar devaluation, to say the least.

Having said that, it seems to me we therefore ought to continue to encourage them on the domestic development side. It has been a mercantilistic economy to the highest degree; we and the rest of the world can no longer tolerate the degree of mercantilism that has driven Japan. At the same time, they are all cramped in these small houses and a whole range of domestic consumption matters have not been met at all, which the Japanese don't like themselves. So they are moving in that direction. We ought to continue to encourage that.

Third, there is a problem of market access and that I don't think you can get away from. A lot of it has to do simply with the fact that they deal with things much more slowly than we do, as you know. But there's just too much of that and we have to continue focusing on that.

I think, other than that, it's primarily in our court or it's something to do with the Germans or other countries, and I can't think of anything else with respect to the Japanese.

Senator **Sarbanes**. What about the Japanese assuming greater international economic responsibilities commensurate with the strength of their economy and their very large current account surpluses?

Mr. **Jasinowski**. I should have thought of that and that's quite right, Mr. Chairman, and I think that they are willing to do some of that and it should be pushed.

Mr. **Hormats**. Just one further point on that last point. One point the Japanese make is that a lot of wealth that they have accumulated is in private hands as opposed to the Government which still has a budget deficit and a big debt.

Now one of the things that needs to be done—in fact, when Minister Obei was here and then when Prime Minister Nakesone was here a while ago, they made the point that they were working on a $20 or $30 billion package to reorient resources toward the Third World—Asia and Latin America in particular. I think that is very much to be encouraged and we ought to be working with them to help them take some of this excess savings and put it into these countries which need the capital, providing the capital is used properly, and that helps us because it enables them to eliminate to a degree one of the resource restraints on their own growth.

Senator **Sarbanes**. I think we need to work with them to assure that it's done multilaterally and not bilaterally as part of a projected trade-tying arrangement. Then they only compound the problem over time.

Representative **Scheuer**. Thank you very much, Mr. Chairman.

Senator **Sarbanes**. Congressman McMillan.

Representative **McMillan**. Well, I would like to pursue just one issue a little bit. Maybe we don't have the data to do it, but to the degree which the decline in the stock market affects consumption, I know there's a psychological side. I know that if you've lost value in your securities portfolio, assuming you haven't made a transaction, it may affect your behavior patterns to some degree. But in all probability, a lot of the stock sold over the last 6 trading days probably was bought in at values way below the levels they were sold for.

So in fact people have converted paper assets into liquid assets probably at a higher liquid value than they went in with.

Mr. **Hormats**. Some of them.

Representative **McMillan**. I don't know how you measure this, but this probably has some tax implications because there have been substantial amounts of capital gains revenues realized in the last 6 days, even though on paper the market declines dramatically.

Mr. **Hormats**. That's an interesting point and we really don't know at this point how that's going to work out. If you're Mr. X and you bought stock Y at $10 and it went up to $30 and then it went down to $20 and you sold it, you've got a 100-percent gain. So you would put that in your tax and pay 38 percent on that.

The other part of the problem is that if you bought at $30 and it went down to $20 and you sold at $20 in the panic, you would get a loss.

How this is going to work out in terms of the way it affects the revenues of the United States is, of course, a problem we don't know.

The other is that there has been an appreciation in the bond market and some of the weakening of the stock market for those who went from stocks to bonds will come in terms of gains in the wealth in the bond market. But how this will work out, this is beyond my knowledge at this point.

Mr. **Jasinowski**. I think that that's a very good point, Congressman, and I would just try to respond to your question by saying to the extent that I have done some modeling of this, of which I'm not setting up here as anything more than a guess at it—what we did was look at the wealth effect of a decline which brought you back to an equilibrium of about 2,000 on the Dow. I'm not getting into the psychological effect. I'm just getting into the economic effect. There's a lot of controversy in economics as to what that finally does, but even with some of the gains you're talking about, there's a sense that the negative wealth effect of that much would have an effect on reducing some consumer spending and some business activity.

And in terms of the simulations as we carried these through with the different linkages, you get I think a reduction in real GNP growth of a percentage point or more over a couple of quarters, which I think is pretty conservative.

Now that did not take into account a large change in interest rates which could occur simultaneously with these. So any of these forecasts really it's awfully hard to get everything moving in the way in which they're going to move, but I would say that you're going to get some negative wealth effect.

I've seen the psychological effect already in terms of reports from some business firms. They are taking a very cautious view of the future as a result of this—not all, but some—and I think all the more reason to get this budget thing settled and try to get some stability around 2,000. I think stability around 2,000 is not bad, but if this thing keeps bouncing around—it's reading about it every day that's as much a problem as anything else.

Mr. **Hormats**. Let me make one further point. I know that on Friday you will be talking about the long-term costs of this, but as a former State Department official I can't resist making one basic point.

That is that there are some——

Senator **Sarbanes**. The State Department always likes to make one last point.

Mr. **Hormats**. That's right, particularly former ones.

There is a very heavy cost here to this whole debt problem in terms of the ability of the United States to maintain an effective foreign policy and an effective national security policy.

The biggest debtor nation in the world is going to have to—the existence of a large debt is going to more than likely mean a decline in the ability of the United States to carry on an effective foreign policy. If we don't have money for countries we want to assist, we're going to constantly be involved in fights with our trading partners over currencies, over trade, over burden sharing, and it could lead to a very serious erosion of our capability to maintain an effective foreign policy.

And the longer we take to deal with our domestic issues, particularly the budget deficit, and the longer we take to work out some general understanding with our trading partners on how to deal with these international imbalances, the more adversely it's going to affect our ability to conduct foreign policy.

So I think that in an environment where we're concerned about the numbers—and we should be—we also have to recognize that there's some very broad foreign policy and national security implications to this debate and, for that reason, among many others, we've got to come to grips with both of the imbalances very quickly. The longer we wait and the greater the measure of uncertainty, the more difficult it's going to be to retain the strength in the world that we want and need.

Senator **Sarbanes**. I think that's an important point. The report published in August talked about the burden of the foreign debt on our living standards and about the constraints it placed on policy, which we are now seeing, and also about the consequences for our international influence. We raised the question whether a country can be a great power and a great debtor at the same time.

The notion that we can project major international influence over a sustained period of time and at the same time be the world's largest debtor nation, I think, just won't hold up.

Mr. **Krugman**. I just wanted to back up for a moment because we're talking about the stock market crash and a strong implication, which I think Congressman Scheuer raised, is that there could be if we handled it correctly a quite substantial silver lining in this crash. We have been complaining for years about the inadequate private savings rate as well as the Federal deficit. We've been complaining that surging consumption demand in the United States makes it necessary for the Federal Reserve to adopt a tight monetary policy which keeps interest rates high, that it makes it too risky to contemplate a further fall in the dollar because that would be inflationary. In fact, we have just gotten what we asked for.

The effect of the stock market crash will surely be some decline in consumption which does mean a rise in the private savings rate and it does offer an opportunity for the Federal Reserve to be more relaxed, more expansionary. It offers an opportunity to cut interest rates.

What I'm greatly concerned about, the way we can turn this into a macroeconomic problem instead of an opportunity, is that the Federal Reserve is inhibited if it says, "Well, we can't actually cut interest rates. We can't actually offset this fall in consumption demand because that would imperil the stability of the dollar."

What I am concerned about, which brings me back to the beginning of this whole session, is that the effort to defend the wrong value of the dollar is going to prevent us from using the stock market crash as an opportunity and instead turn it into a liability.

Senator **SARBANES**. Let me ask the panel one final question. I am concerned about the fact that the Sun never sets on the stock market now, so to speak, and that you have perhaps the stock markets feeding off one another. The U.S. market closes and it's down. Then the Japanese market opens up, and they see that the U.S. market was down and respond accordingly. They go down and then that gets transferred to Europe. Then it comes back to the United States, which reacts to the fact that the other markets have gone down in reaction to the fact that the U.S. market went down the day before, and on and on it goes.

First of all, how serious a problem is this? Second, what, if anything, might be done about it?

Mr. **HORMATS**. It is a problem and it's a peculiar problem in the sense that it's sort of time across time zone contamination. One market feeds on another or reacts to another or anticipates another.

For instance, the decline in the Japanese stock market a couple of days ago was the result not of anything that they were concerned about directly, but they thought that the American market might go down, so there were people in Japan who said, "Well, the American market might go down, so we will sell, too, to anticipate that."

So it is the downside effect of interdependence and of integrated markets. I don't think there is much you can do about it in a regulatory sense because there are these markets and they all have the same information and they all try to anticipate or react to one another.

I do think that it's the persistence of major imbalances in the world economy which feed this underlying apprehension and this underlying sense of volatility. If basically there was a greater degree of equilibrium in the system and there weren't as many imbalances within the system or within the U.S. economy, I don't think you would see that apprehension that does tend to feed this interactive volatility.

Senator SARBANES. Does anyone else want to add anything?

Mr. KRUGMAN. I think you could easily exaggerate how important a difference it makes that we have all this instantaneous communication and the worldwide market. I think if investors are determined to panic, they are going to find a way, whatever the technology. And I don't think it really makes that much difference that we have better communications technology than we did.

And I think that having brakes on stopping it doesn't necessarily do you much good. The experience of the Hong Kong market I think demonstrates that. It can be just as bad or worse to close the market for a few days and give investors time to let the juices turn in their stomachs as it is to let the trading go on.

I think the real problem, as Bob Hormats said, is not that there's something wrong with the financial markets. Of course, something went wrong. Investors made a big mistake, both on the upside and probably on the downside. But the real problem is that we haven't given them a world economy they can believe in. So why should we expect the financial markets to work very well?

Mr. JASINOWSKI. I'm no expert in this area, Mr. Chairman, and I certainly would be reluctant to urge major regulation here, but I do think that it's an area that requires major investigation. I am disturbed by the difference in margin requirements, for example, that exist between U.S. instruments and between the way stocks and investments are handled from one country to another. That does make an enormous difference in terms of how these items are perceived around the world.

I'm not sure we can regulate that, but certainly it seems to me that the question of margin requirements is one example of—I mean, we change the entire nature of the product as we move around the world depending upon what kind of margin requirements are required. So I think it really bears very careful investigation at this point. Let's try to get more facts would be my recommendation.

Senator SARBANES. Well, gentlemen, thank you very much. You have been a very helpful panel and we appreciate it.

The committee will stand adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

THE U.S. INTERNATIONAL IMBALANCES

FRIDAY, OCTOBER 30, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 9:45 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Bingaman; and Representatives Solarz and McMillan.

Also present: Judith Davison, executive director; and Lee Price, Dan Bond, Jim Klumpner, and John Starrels, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator **Sarbanes**. The committee will come to order.

I apologize for this delay but there was a vote on the floor of the Senate and at the time it began neither of my colleagues was here, so I wasn't in a position to turn the hearing over to them.

Today the committee continues hearings to review the U.S. international accounts. At the first hearing earlier this week we heard testimony on the near-term prospects for our trade performance and on the interconnections of our trade deficits, foreign borrowing and financial markets. The purpose of today's hearing is to look ahead to some of the longer term consequences, in both economic and political terms, of the continuing U.S. deficit position.

As we move into the closing months of 1987, I regret very much having to say that it's increasingly apparent the trade deficit will not decline this year, and indeed now appears almost certain to rise. As a consequence, the U.S. foreign debt will rise even more steeply than anticipated, since every dollar on the deficit translates into an additional dollar of foreign indebtedness. Therefore, by the end of the year, we may find our foreign debt exceeds $400 billion.

The continuing deficits and rapidly growing foreign debt have, as the study issued by the committee in August clearly indicated, serious financial consequences and, more broadly, raise serious questions with respect to the future U.S. standard of living and the leadership role which the United States has played in the world in the post-World War II era. In the August study, "A Legacy of Debt," it was pointed out that no country has managed to be a great power and a great debtor at the same time.

The committee is hardly alone in expressing this concern. The June Economic Summit in Venice was widely regarded as a reflection of declining U.S. influence and leadership on critical economic questions. As the late Walter Heller, the distinguished former Chairman of the Council of Economic Advisers, once remarked, "You can't ride tall in the saddle when you owe everybody in town."

We begin this morning's hearing with testimony from Robert Ortner, Under Secretary for Economic Affairs and Chief Economist in the Department of Commerce. In testifying before this committee in July, Malcolm Baldrige, the late Secretary of Commerce, a very distinguished public servant, projected a $20 billion decline in the trade deficit in 1987. Since the deficit is running at a higher rate this year than last, we expect a revised analysis of the trade situation.

I understand, Mr. Ortner, you have some time pressures and the committee will try to respect that. I gather you have to be back at the Commerce Department by 11 o'clock.

Mr. ORTNER. Yes, sir.

Senator SARBANES. You will be followed by a panel of two very distinguished witnesses, Anthony Solomon, currently chairman of the board of S.G. Warburg, earlier Under Secretary of the Treasury from 1977 to 1979 and then president of the Federal Reserve Bank of New York from 1979 to 1985; to be joined on the panel by Stephen Marris, who's been senior fellow at the Institute for International Economics here in Washington, after nearly 30 years of experience in the Organization for Economic Cooperation and Development in Paris.

Before we begin, I am going to insert in the hearing record the written opening statement of Senator D'Amato, at his request, at this point.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL DISCUSS THE LONG TERM COSTS OF THE TRADE DEFICIT AND FOREIGN DEBT.

IT IS QUITE CLEAR THAT THE ENORMOUS FEDERAL DEFICIT AND TRADE DEFICITS MUST BE DEALT WITH IN AN EXPEDITIOUS MANNER. AMERICAN AND FOREIGN INVESTORS ALIKE ARE LOSING CONFIDENCE IN THE FEDERAL GOVERNMENT'S ABILITY TO TAKE ACTION ON THESE TWO PRESSING PROBLEMS. THIS INACTION IS WIDELY SEEN AS HAVING BEEN AT LEAST PARTIALLY TO BLAME FOR THE 508 POINT LOSS IN THE DOW ON BLACK MONDAY.

THE FIRST STEP IN ADDRESSING THE PROBLEM HAS ALREADY BEEN TAKEN. THE PRESIDENT HAS BEEN MEETING WITH BIPARTISAN DELEGATIONS FROM CONGRESS TO DEVISE A PLAN TO SAVE THE FEDERAL GOVERNMENT SOME $23 BILLION FOR FISCAL YEAR 1988.

IT IS ESSENTIAL THAT WE TAKE ACTION TO BALANCE THESE TWO LOOMING DEFICITS IN ORDER TO RESTORE MUCH NEEDED CONFIDENCE IN THE FINANCIAL MARKETS. PROLONGED PERIODS OF MARKET

VOLATILITY CREATE AN INSTABILITY RAISING THE SPECTRE OF A WORLDWIDE RECESSION.

AT WEDNESDAY'S HEARING DISCUSSION CENTERED ON THE SAVINGS RATE IN THIS COUNTRY. THE SAVINGS RATE IN THE U.S. IS ONE OF THE LOWEST IN THE WORLD. AMERICANS ARE MORE APT TO SPEND THEIR HARD EARNED DOLLARS THAN TO BANK THEM. THE FEDERAL GOVERNMENT HAS THE SAME PROBLEM. OVERSPENDING IS OBVIOUSLY THE LEADING FACTOR IN THE BLOSSOMING FEDERAL DEFICIT.

IT IS CLEAR THAT THERE IS A LONG AND PERILOUS ROAD AHEAD. WE WILL BE CONFRONTED WITH HARD CHOICES. THE PRESENT COOPERATIVE EFFORT BETWEEN THE PRESIDENT AND CONGRESS IS AN INITIAL STEP - BUT ONLY AN INITIAL STEP - IN THE RIGHT DIRECTION. I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES AND TO ANY INSIGHT THEY MAY PROVIDE THIS COMMITTEE ON AN APPROACH TO THE TRADE DEFICIT.

THANK YOU, MR. CHAIRMAN.

Senator **Sarbanes**. Mr. Ortner, I think we're prepared to hear from you if you will proceed. Your prepared statement will be included in the record and you may proceed as you choose in terms of either abridging it or delivering it. Please go ahead.

STATEMENT OF ROBERT ORTNER, UNDER SECRETARY FOR ECONOMIC AFFAIRS, U.S. DEPARTMENT OF COMMERCE

Mr. **Ortner**. I would like to deliver it, Mr. Chairman, and I'd like to say at the outset that I am pleased to appear before the Joint Economic Committee to discuss U.S. performance in international trade and the outlook for further improvement in our trade accounts.

This month, the U.S. economy achieved its longest peacetime expansion in 133 years of recordkeeping by the National Bureau of Economic Research. Since late 1982, employment has increased almost 14 million, the unemployment rate has dropped 4.9 percentage points to 5.9 percent, and the percent of the population that is employed has reached a record high. No signs of accelerating inflation or credit pressures exist that would normally signal the approach of a recession.

Despite this long and generally well-balanced expansion, our trade balance deteriorated from a surplus in 1981 to a record deficit. The widening trade deficits during the last few years were caused by a number of factors, including but not limited to, an overpriced dollar, slow growth abroad, financial problems of less developed countries—so-called LDC's—who cut their imports, much of those imports coming from the United States, and a reputation which was fair or unfair of poor quality and style of U.S. products. Increases in the budget deficit contributed to higher trade deficits in two ways. They stimulated domestic growth and therefore increased imports, and deficit financing raised interest rates in the United States and therefore raised the value of the dollar.

While Americans took advantage of the rising value of the dollar and increased their purchases of goods and services from abroad, foreigners chose to spend a smaller share of their U.S.-earned income on U.S. goods and services. And by U.S.-earned income, I mean their exports to the United States. They sold goods here and earned income here. This increase in foreign saving, or capital inflow into the United States, which is the mirror image of our trade deficit, restrained somewhat the growth in our economy. And contrary to some comments that foreigners are financing our expansion or a large share of it, they supplied only 13.6 percent of credit raised by all nonfinancial sectors of our economy during 1986.

Conversely, the coming declines in our trade balance and capital inflows will stimulate growth in our economy, not dampen it. While some sectors of the economy grew less rapidly during the recovery than they might have with lower imports, America did not "deindustrialize." The manufacturing share of GNP has been relatively constant—21.9 percent in 1986 compared with 21.6 percent in 1984 and 20.3 percent in 1960. It is likely that manufacturing's share of GNP will rise in the next year as exports continue to expand rapidly and manufacturers recover the share of the domestic markets they lost in recent years.

During the last four quarters, the nominal trade deficit—that is, the reported trade deficit unadjusted for price changes—has begun to level off. However, this balance is not the only measure and maybe not the primary measure to consider in formulating economic and foreign trade policy. In fact, the unadjusted data can be misleading, especially the initial monthly data released by the Census Bureau that receives such widespread attention. These data include the effects of seasonal fluctuations and changes in prices. Until recently, they were incomplete because of late reporting by customs agents and deficit reporting by some American exporters to Canada. We have made improvements in both these areas by working with the U.S. Customs Service and with the Canadian Government.

Most important, in my opinion, the monthly data from the Census Bureau do not show the dramatic improvement in our real trade balance. The drop in the value of the dollar has already set in motion a typical process of improvement in which import prices rise sharply, export prices rise less rapidly than foreign prices, and trade volumes, both exports and imports, begin to shift favorably. During the last four quarters, real exports rose 16.2 percent following an 8.1 percent gain in the previous four quarters. Excluding the volatile oil component, real merchandise imports rose 2.2 percent following a 13.4-percent rise in the previous year. This shift in our merchandise trade balance contributed three-quarters of a percentage point to real GNP growth during the last four quarters, or about one-fourth of total growth in our economy. This is a clear-cut change from the pattern of earlier years.

The near-term outlook for our real trade balance is for continued improvement. The recovery in our trade accounts would be accelerated by faster growth among our industrial trading partners, resolution of LDC debt problems, and removal of foreign trade barriers. But it is important to note that our economy is already benefiting from strong exports and an improving share of domestic sales. These developments contributed to an 8.2-percent increase in new orders for durable goods from year-ago levels. New orders for nondefense capital goods are up 14.7 percent. Business investment in equipment rose sharply in the last two quarters. Initial claims for unemployment insurance, a leading indicator, are down to levels last seen in early 1974. Industrial production rose at an annual rate of 8.7 percent in the third quarter, the strongest quarterly gain in 3½ years.

The nominal trade balance will begin to reflect improvements in the real trade balance when the rise in import prices begins to slow down. Import prices, as measured by the fixed-weighted price index from the GNP accounts, jumped 12.7 percent in the last four quarters. In contrast, export prices increased 2.7 percent. The large nominal trade deficits of recent years have resulted in a sharp decline in the net investment position of the United States. The value of foreign-owned assets in the United States probably exceeds the value of U.S. assets abroad by about $330 billion to $340 billion at the present time. The gap will continue to widen as long as our current account is in deficit, and that is essentially by definition.

As a result, income payments to foreigners will rise faster than our income from abroad. Our receipts from foreigners still exceed our payments, but the surplus has fallen from $18.5 billion in 1984 to $6.4 billion, at an annual rate, in the second quarter. This surplus will disappear in the near future.

A return to a balanced U.S. current account, therefore, may require surpluses in our merchandise trade balance. Contrary to our experience in the last few years, we will have to produce more than we purchase for consumption and investment. That change already has begun. In recent quarters, growth in domestic production has been larger than the increases in our total domestic purchases. In Germany and Japan, the opposite is occurring. Growth in their production has begun to lag behind increases in purchases.

This does not mean that our standard of living is declining now, or that it must decline in the future, or that it must fall behind the standards of living in other major industrial countries.

The U.S. standard of living, as measured by gross domestic product per capita, is higher than in all other industrialized countries. In 1986, the GDP per capita for Canada was 93.5 percent of the U.S. level; for Japan, only 71 percent; and for Germany, 73.7 percent.

In the postwar period, foreign industrial economies have improved their position relative to the U.S. standard, having benefited from U.S. insistence on open economies and the rapid spread of new technologies. We should continue to make gains in our own standard of living without falling behind. Intense competition from foreign producers has accelerated the pace of structural change within the U.S. economy and increased its efficiency, which is the key determinant of our own living standards. In 1986, U.S. manufacturing productivity rose 3.5 percent, well above the trend rate since 1973, and better than the performance of nine other major industrial countries.

This is the picture of a dynamic economy, one that shows resiliency under severe pressure. Within every industry, even those severely pressed by foreign producers, individual firms are demonstrating that the United States can compete. This vitality should be encouraged and rewarded. A move toward greater trade restriction would cut off our rapid growth in exports and, by raising costs, would hamper those producers who are making genuine progress, and would inevitably slow the growth in our standard of living.

That's my statement, Mr. Chairman, and if you have questions I will try to answer them.

Senator **Sarbanes**. Thank you very much, Mr. Ortner.

I think we'd better limit it to 5 minutes and then maybe we'll get a second round.

I must say, listening to your statement, that I have a sense of being divorced from reality. Here I have an article by Hobart Rowen that says, "Gloomy Economic News Helps Set the Scene for Market's Nosedive." That's dominating the front pages of the newspapers and the concerns of the people. Yet your statement suggests "no problem."

It's kind of "no problem," a dynamic economy, one of resiliency and so forth and so on.

I find it impossible to square that analysis with the following comment, and I'm going to read it to you and ask your reaction. It says, "Then on Wednesday, October 14, that something the stock market had been waiting for happened. Early that day the Commerce Department published a long awaited report on the nation's merchandise trade deficit showing that the deficit in August had narrowed only to $15.68 billion from $16.47 billion in July. Worst of all, there was no improvement in exports. The result that day was a record drop at that time of 95.46 points on the Dow Jones industrial average. The trade report was widely seen as evidence that the trade gap was not closing as the administration had expected. New York investment banker, Jeffrey Bell, said, 'When we saw those trade figures, there was a realization that the trade deficit was not going to improve, that the dollar would have to go down and interest rates would have to go up, and obviously that wasn't going to be good for the economy.' There was also the realization that sooner or later foreigners would lose their faith in the dollar."

Now your Secretary was here a few months ago and he said the trade deficit was going to improve by $20 billion. He wasn't talking in real terms. He was at that point referring to nominal terms. Of course, as long as it worsens in nominal terms, our debt situation worsens because that's the measure, is it not?

Mr. **Ortner**. The net investment position is related not only to the nominal trade figures but of course the total current account, which is in nominal terms.

Senator **Sarbanes**. Yes. So as long as it worsens in nominal terms, our net asset position worsens. Isn't that correct?

Mr. **Ortner**. The net investment position would decline.

Senator **Sarbanes**. What's your reaction to this observation, that it was the trade figures that helped to produce the situation, and how do you relate it to your statement—I don't think it's an excess to describe it as "Pollyannish"—to what's now occurring in the economy?

Mr. **Ortner**. Well, let me comment both on that, if I may, and I will try to reconcile that with some of the comments which I made in my statement.

For one thing, by way of background, I would repeat something that we always say—nearly always say whenever we release a monthly statistic of any kind, and that is, almost all of our monthly statistics are subject to a great deal of random volatility and that we do not observe trends in the economy based on only 1 month's numbers.

Beyond that, I would like to go back and emphasize the comparison or discrepancy between the nominal trade figures and the real volume of the trade balance.

You referred to the nominal figures as related to the net investment position, and that is true. I would emphasize that it is the real trade balance that is plugged into our economy. It is the real trade balance that is related to real GNP growth, related to industrial production, related to jobs.

I mentioned growth in employment, for example. Over the past year, we have had a very healthy turnaround in employment in manufacturing. That is partly related to changes in the real trade volume.

And taking a perspective on those two sets of figures, let me emphasize that over the past year we have had an increase in real exports of about 16 percent. I mentioned an increase in export prices of about 3 percent, a total gain of 19 percent.

On the import side, we have had a similar total gain, 18 or 19 percent, but that is made up of an increase of 13 to 14 percent in prices and only 2 percent or so in real volume.

So what we are seeing in the nominal numbers over the past year is an offset so far by a large increase in import prices against a large increase in export volume. And that is masking a healthy improvement in the real volume of trade.

I mentioned in my statement that this pattern usually goes through a sequence. First, the import prices rise, the real volumes begin to shift. This process is underway. And then the import prices will and should begin to slow down—the increases should begin to slow down. The third quarter increases were a little less. Maybe that's the first sign of some slowdown in import prices. And then I think we'll begin to see some improvement in the nominal balance as well.

In my opinion, sir, I would emphasize the real volume and its effects at this juncture rather than the nominal figures and their effects.

Senator **Sarbanes**. It's an important point to make, but it still doesn't gainsay the fact that we are going deeper into debt and, therefore, facing a growing burden in terms of meeting the obligations that foreigners now hold over the American economy. Isn't that correct?

Mr. **Ortner**. If I may interpret it in my way, sir, in responding, the United States has been referred to as a debtor nation and you comment that we are going into debt.

We are in no way in any kind of similar position to other debtor countries such as Mexico and Brazil, countries that have been getting a lot of publicity. Foreigners are accumulating assets in the United States because we buy goods from them, pay them for those goods. They buy fewer goods from us than we buy from them, so they end up with more dollars and they invest those dollars in the United States.

The United States, as a country, is not borrowing money from other countries. It is interesting to see, therefore, in what form the foreigners are holding these assets. At the end of 1986, our figures show that foreigners held 1.3 trillion dollars' worth of assets in the United States. Over $200 billion was in direct investments, much of that in plants that they own and companies that they own in the United States.

For example, I don't think it's a bad thing that Honda has built a plant in Ohio, which is adding to our production in the United States and adding to jobs and employment in the United States.

Senator **Sarbanes**. Mr. Ortner, let me——

Mr. **Ortner**. They also own 300 billion dollars' worth of corporate stocks and bonds which they buy voluntarily. That doesn't make us a debtor nation.

So I think I would distinguish carefully between those two kinds of concepts.

Senator **Sarbanes**. This chart shows the U.S. net external asset balance in billions.

Mr. **Ortner**. Yes, sir.

Senator **Sarbanes**. And this is 1980 and this is 1986 [indicating]. Here we were in surplus and now we're in deficit and the next year this will obviously worsen, will it not, since the nominal trade deficit is going to be negative?

Mr. **Ortner**. Foreigners will accumulate more assets in the United States relative to our assets abroad by approximately the amount of our current account deficit because we are buying more goods from them than they are buying from us, not that the United States is borrowing money.

Senator **Sarbanes**. When was the United States last in a deficit position in its net external asset balance?

Mr. **Ortner**. 1914 or 1915, as I recollect. We have another expert here who might remember.

Senator **Sarbanes**. Well, that squares with my understanding. In other words, before World War I. So we have gone from being in a creditor position throughout the period since the beginning of World War I to this debtor position. It seems to me a matter of concern, not a matter that can be shrugged away as "no problem."

Mr. **Ortner**. I'm not trying to shrug it away. I'm trying to put in perspective.

Senator **Sarbanes**. Is it a matter of concern?

Mr. **Ortner**. In a sense, yes, for one of the reasons that I gave. That is, dividend and interest payments on the securities and direct investment owned by foreigners will be growing more rapidly than our investment income from abroad and we will have a net outflow in the near future. And in order to bring our current account into balance, we will have to then have a surplus in foreign trade. We will have to produce more and more for export. That has to be paid. That is true. Whether this is a sword hanging over our economy and will destroy our economy in any sense—I don't believe that that is the case at all.

We would be better off, in my opinion, with a net investment income. This would add to our well-being. I would rather see that.

Senator **Sarbanes**. So the position has deteriorated pretty severely, has it not?

Mr. **Ortner**. Our net investment position has deteriorated, sir. That is correct. And it will deteriorate again this year.

Senator **Sarbanes**. When do you think it will stop deteriorating?

Mr. **Ortner**. It will stop deteriorating statistically when our foreign trade is in balance again.

Senator **Sarbanes**. When do you expect that to be?

Mr. **Ortner**. Well, I didn't come prepared with a precise forecast. That could take 4 or 5 years or more. Toward the end of that period, the trade deficits, if they are shrinking, should be relatively small and that account will not be changing very much.

Senator **Sarbanes**. Senator Bingaman.

Senator **Bingaman**. Thank you, Mr. Chairman.

Let me ask a question on the same issue. You see the turnaround in our current account as a result of the fact that we will gain a significant surplus in our merchandise trade balance, is that right? As I understand your testimony, you are saying that we will no longer have a surplus in income payments. We will have a deficit in income payments because of the things that Senator Sarbanes was referring to.

Mr. ORTNER. Right.

Senator BINGAMAN. The way we get our current account into balance with a deficit in income payments is to have a surplus in the merchandise trade balance, and you expect us to have that surplus within 4 or 5 years?

Mr. ORTNER. I would expect to see substantial declines in the trade deficit and I would hope to see it close to balance over that period of time. I can't give you a more precise forecast than that.

Senator BINGAMAN. I'm just interested in the components of that merchandise trade balance in which you see us gaining significantly. We've got to make up $160 billion or $170 billion—I'm not sure what it's expected to be this year. Do you have a projection for this year for the trade balance?

Mr. ORTNER. Well, the first 8 months of the year we have a deficit of $114 billion and were we to continue at the same rate that would add another $57 billion, and I think it might be somewhat less than that. A rough guess might be $155 or $160 billion. I do think it will slow down over the next few months.

Senator SARBANES. What was it last year?

Mr. ORTNER. $156 billion, sir. If I may say a word on behalf of our late Secretary Malcolm Baldrige, when he testified before you and he suggested to you that we would see an improvement this year, I am aware that he did not expect the kind of jump in import prices that we have seen since last year. They have been enormous. We are seeing a very substantial improvement in real volume and some of that would have shown up in the nominal figures as well by now if we didn't have that kind of an updraft in import prices.

Senator BINGAMAN. You talk about one item in your testimony—"the volatile oil component," and I agree it's volatile. Then you exclude it from one of your calculations.

All the projections that I've seen from the Department of Energy and others who have studied this matter are that our imports on oil are going to increase in the next 4 or 5 years fairly significantly. We're at about 40 percent of our domestic oil consumption is imported now. It will be about 50 percent in 2 or 3 years. That's the figures that I've seen. And maybe 60 percent by 4 or 5 years from now.

How is that increase in imports going to be offset as we gain a surplus in this merchandise trade balance?

Mr. ORTNER. Well, for one thing, the imports would also be affected by continuing improvement in our efficiency in the use of energy in the United States which we have improved substantially in recent years.

Nonetheless, I think you virtually answer your own question, sir. If the oil imports rise substantially more, in order to bring our trade into balance we will have to export more goods of other kinds, which we can do.

Senator BINGAMAN. But do your projections that we're going to have a balance in our trade account take into account the fact that we are going to increase our oil imports significantly over that same period?

Mr. **Ortner**. I don't know their numbers. I would assume some moderate increase. I can't speak for their figures.

Senator **Bingaman**. Let me ask you about your comments on the standard of living. You say that we should continue to make gains in our own standard of living without falling behind. Earlier this year, the Council of Competitiveness, which is headed by John Young did an update report on our competitive problem. Let me just read you three sentences out of the report.

"U.S. standard of living has been growing much more slowly than in the past. Real wages have actually declined. From 1973 to 1985, real average hourly wages in all nonagricultural sectors in the U.S. fell by about 5 percent. Since 1979 corporate profitability has also decreased. Furthermore, the new jobs created in the U.S. from 1979 to 1985, some areas of the service and retail trade sector, for instance, pay on average far less—$272 weekly wage—than did the jobs that were lost—$444 weekly wage."

Do you agree with that conclusion about the decline in real wages?

Mr. **Ortner**. I have to agree with the numbers. Let me say more correctly, I agree with the numbers but I do not agree with the conclusion. If I may explain what I mean by that, taking a period from 1973 through 1985, I think you referred to, or the late 1970's through 1985, is a very unfortunate kind of period for analysis.

Senator **Bingaman**. Particularly for the folks whose real wages declined.

Mr. **Ortner**. Let me change that, if I may. It is a misleading period for analysis. We had a terrible bout with hyperinflation during the late 1970's and while it may be true statistically—and that's why I said I have to agree with the numbers—that we had some deterioration perhaps—and I would want to check them—that deterioration occurred in the late 1970's. We had a huge increase, a second round increase in oil prices in 1979–80. We had an enormous inflation rate then.

But it wasn't just oil prices, as I remember, which jumped in 1979. If I'm not mistaken, inflation had already gone back up to 9 percent in 1978 and then the economy slowed down and employment didn't rise as a result of that. I think that that relationship is very clear and the economy didn't come out of that stagnation until inflation and interest rates came down. And that took us through 1982.

Since 1982, you have a completely different picture, which is not described at all by that statement. For example, in the figures we released this summer from our own Census Bureau, we showed that real family incomes have increased more than in any 4-year period since the late 1960's.

Senator **Sarbanes**. Which 4-year period are you talking about?

Mr. **Ortner**. From 1982 to 1986. This is a homogeneous period.

Senator **Sarbanes**. So the beginning reference point of that period was the worst recession since the 1930's?

Mr. **Ortner**. May I respond to that, sir?

Senator **Sarbanes**. I'm sorry.

Senator **Bingaman**. Go ahead. My time is up. Go right ahead.

Mr. **Ortner**. We had a high-unemployment rate at the end of that recession, sir, which in one sense——

Senator **Sarbanes**. Almost 11 percent.

Mr. **Ortner**. It was 10¾ percent. You're absolutely right, Mr. Chairman. And it was a record high postwar unemployment rate. The unemployment rate when we entered that recession, however, was also a record high for a business cycle peak, and that reflected the stagnation in the economy that we had since the end of 1978.

The decline in the economy and the amount of increase in unemployment and in the unemployment rate were not records, and in that sense, it was more of a typical recession rather than the worst recession that we have had in the postwar period or previously.

Senator **Sarbanes**. At the beginning of the 1982-86 period you are using to make this real wage statement comparison, we had unemployment close to 11 percent, which was something we had not experienced since the 1930's. Isn't that correct?

Mr. **Ortner**. I'm beginning from the end of the period in which we came through some enormous problems in our economy. But what I'm trying to emphasize, going from the middle 1970's to the middle 1980's is not a homogeneous period and, in one sense, we're comparing apples and oranges. All the problems that are referred to in some of those numbers for declining real wages didn't occur in the 1980's. They occurred essentially in the late 1970's, carried into the very beginning of this decade because of the problems that we had at the end of the last decade.

Senator **Sarbanes**. Mr. Ortner, I'm the first to agree that the period over which you're making the comparisons of changes in real wages is highly relevant. But you're the one who asserted to the committee that an impressive improvement in real wages had occurred and what you took as the beginning point in this period was an incredibly deep recession and very high unemployment, when real wages would obviously be down. So you start with that low point and then make this comparison. That's the only point I'm making.

Now you have to make that kind of analysis with any period that you use as your reference period, but to give us the 1982-86 period, when the base against which you're comparing real wages was obviously depressed because of the economic conditions, that is questionable. I just want to make that point.

Let me ask you this question. Did your leading indicators this morning show a decline, as I understand it?

Mr. **Ortner**. They were down one-tenth of 1 percent, which I would regard as a flat change—virtually unchanged.

Senator **Sarbanes**. When was the last time the monthly economic indicators were down?

Mr. **Ortner**. January, sir.

Senator **Sarbanes**. Last January, almost a year ago?

Mr. **Ortner**. January 1987, and they were down six-tenths of a percent in January.

These indicators, by the way—and this is one of the reasons that I said that we emphasize that we shouldn't take 1 month's numbers as a trend and that's especially true of these indicators and many of their components—it was down one-tenth of a percent, as I said, in September. It was down six-tenths of a percent in January.

Senator **Sarbanes**. I have one question about your statement. You note that our receipts from foreigners still exceed our payments but the surplus has fallen from $18.5 billion in 1984 to $6.4 billion at an annual rate in the second quarter.

Mr. **Ortner**. Yes, sir.

Senator **Sarbanes**. "This surplus will disappear in the near future." Obviously, as there is an increase in the amount of foreign-owned assets in the United States on which we're going to have to pay dividends and interest, we are going to make larger income payments to foreigners than we receive from them. Is that not correct? And that's what you anticipate happening?

Mr. **Ortner**. Yes. I'm acknowledging the accumulation of assets owned by foreigners and they will be receiving dividends, interest, profit remittances. For example, from the factory that I referred to before, the Honda plant in Ohio, there will be earnings going back to Japan that would be included in that.

Senator **Sarbanes**. Then on the next sentence you say, "A return to a balanced U.S. current account, therefore, may"—and I underscore that word—"may require surpluses in our merchandise trade balance."

Will it not absolutely require surpluses in the merchandise trade balance? We are losing the surplus with respect to our receipts from foreigners. Debt service on our growing foreign indebtedness is rising rapidly. In fact, the current account will soon be worse than the merchandise trade balance, will it not?

Mr. **Ortner**. Well, the reason that I say "may" is that the balance in investment income is not the only other component of the current account balance. There are other components of services in the current account and then there are also amounts of remittances sent abroad by private citizens and companies in the United States and by the U.S. Government. There are a number of other items that go into the current account balance. And then I have to acknowledge as well that people, institutions, companies, do not always report everything accurately to the Customs Service or to the Census Bureau and, therefore, there is sometimes a substantial discrepancy in these accounts, which we refer to as a statistical discrepancy. So taking all of that into account, I thought it prudent to include the word "may."

Senator **Sarbanes**. Do you anticipate under current trend lines that the current account will soon be worse than the merchandise trade balance?

Mr. **Ortner**. I think it may be in the near future, but I think that it will begin to follow the pattern of the trade balance.

Senator **Sarbanes**. Well, if it becomes worse, then you're really going to be on the trade. We're talking about enormous figures here—$170 billion.

Mr. **Ortner**. Last year's trade deficit in the monthly number that you were talking about before was $156 billion. In the balance of payments accounts, of which the current account is a part, it's accounted for in a somewhat different way, basically similar, but there are some differences—the trade deficit in 1986 was $144 billion. The current account deficit was $141 billion.

Senator **Sarbanes**. Let me just make one final observation. I think the situation is far more pressing than your statement would indicate. Even to the extent that you see a problem instead of saying "no problem, no problem," the items you point to for recovery in our trade accounts—faster growth among our industrial trading partners, is that correct? That's one item——

Mr. Ortner. Yes. I said that that could speed up the process.

Senator Sarbanes [continuing]. Resolution of the LDC debt problem, removal of foreign import barriers—and yet there's been very little advance in any of those three areas. Isn't that correct?

Mr. Ortner. That's correct, sir. And in real volume in our GNP accounts, we've had something like a $30 billion improvement even without that. And if those things improve, it would help.

Senator Sarbanes. Senator Bingaman.

Senator Bingaman. Let my just clarify one point. When we were talking about real wages, you cited the period from 1982 to 1986. I think we got a little confused.

I have a chart here from the Young Commission that shows average hourly earnings. It shows there's been only a slight increase in average hourly earnings during the period from 1982 until the end of 1986. But earlier you were citing a significant improvement in family incomes, as I understand it.

Mr. Ortner. Real family income.

Senator Bingaman. And that's gone up because so many more family members have gone to work; is that right?

Mr. Ortner. There are more family members at work. The participation in the labor force is at an alltime high, along with the employment to population ratio, and that affects family income to some extent.

Senator Bingaman. Thank you, Mr. Chairman.

Senator Sarbanes. If I could pursue this for a minute, as I understand it, the chart that Senator Bingaman was referring to shows the average hourly earnings for all nonagricultural establishments and it's in constant dollars. Of course, what it shows is a very sharp falloff in average hourly earnings.

Mr. Ortner. I can't see that. What dates are those, sir, where it falls off?

Senator Sarbanes. This is 1977, 1978, 1979, 1980, 1981, and on out to 1986.

Mr. Ortner. I mean the decline that you're showing me there. In what dates did it decline?

Senator Sarbanes. 1978 through 1980 and 1981. So you have this falloff in the average hourly earnings. Now you were using real family income, is that right?

Mr. Ortner. Yes, sir. I referred to family because I didn't have these—I hadn't seen this chart. I didn't have those figures in my head. I had seen those other figures. They are published by our own agency and I was familiar with them and that's why I cited them.

Senator Sarbanes. So we have a situation in which the wife went to work because the earnings were inadequate. But by your standard that would really reflect an increase in real family income, is that correct?

Mr. Ortner. Wives did go to work. The female participation in the labor force has gone up. Perhaps it reflects that. I think it has for males also. But I wouldn't agree that it was a matter of necessity. I think it is largely voluntary.

Senator Sarbanes. Congressman McMillan.

Representative McMillan. I apologize for the interruption. The House was having a journal vote and now they're having a vote on the motion to adjourn. It's behaving a little bit like the stock market. It seems to be operating on its own momentum, totally unrelated to anything that's going on in the outside world.

One of the things—I don't know what ground you covered, but one of the things that concerns me is the degree to which our trade deficit is centered upon certain specific industries that seem to have an extraordinary impact on the trade figures and consequently everything related thereto.

I don't have these figures before me, but the sectoral trade deficit would rank, first, oil; second, automobiles; third, probably textiles or steel; and fourth, the other. Taken together these four sectors constitute as much as two-thirds of the trade deficit. Would that be accurate?

Mr. Ortner. I can't confirm that to you at the moment. If you like, I'll check that and respond to you in writing.

Representative McMillan. Because it seems that a number of the issues we face are centered around a very limited number of industries. I could throw in agriculture I guess as a major item that's affected, particularly on the export side.

Mr. Ortner. I think we may be in surplus in agriculture at this point.

Representative McMillan. But far less of a surplus than previously. It used to be a very significant export sector.

Mr. Ortner. Well, going from either a trade surplus or a small trade deficit up to a large trade deficit means that we have had an enormous amount of shift in a number of areas. It couldn't have been accomplished in only one industry.

Representative McMillan. Well, I think some of that is instructive. There was some publicity on the subject this past week and I believe that our import deficit figures are influenced extraordinarily by a very few industries. Yet our approach to the problem seems to be conducted on a broad scale that is not targeted to those specific areas.

We are faced with a situation of the tail wagging the dog, so to speak. And I think that better understanding of that fact would lead to a more sensible approach to dealing with the problem.

Mr. Ortner. There are some general factors that affected all of those industries. There are many crosscurrents in these economic processes. For example, I don't want to oversimplify, but the dollar was a major factor in the buildup of our trade deficit. And with the dollar down at a more competitive level now, we are beginning to see a shift in the real volume of trade and it's affecting all of these industries.

Representative McMillan. I don't know whether you've got figures to address this or not handy today, involving long-term historic trends in foreign investment in the United States.

It's my perception that over our history we have been dependent on foreign capital for development of this country. Granted, foreign investment has perhaps stepped up significantly in the past several years, but it would be interesting to compare that with what existed over time to get the current buildup of foreign investment into perspective to make judgments with respect to any vulnerabilities that it imposes upon us.

Would you have any comment that you would want to make on that at this point?

Mr. ORTNER. Well, I don't have with me the historical trends of foreign investment in the United States and certainly not by type of investment, but I would like to take the opportunity to point out that what's going on now is very different from the situation of other countries which are debtor countries and different from what it would be in the United States if the United States were consciously borrowing money from other countries.

Foreign investors are investing in the United States very heavily, willingly. They are buying corporate stocks and bonds. They are making direct investments. They are doing this because they think the United States is a strong, healthy economy. The United States is not borrowing money from other countries because we are a weak economy.

Senator SARBANES. We're paying a better price, aren't we?

Mr. ORTNER. These people who are investing in the United States will be earning interest and dividends. That is very true. To the extent that this is going into new plant and equipment expenditures—and much of it is—it is strengthening our own economy at the same time. So we can't say simply that foreign investment in the United States is a negative factor for us.

Senator SARBANES. Are our interest rates above the interest rates in other countries?

Mr. ORTNER. Oh, they are above the interest rates in the countries who are our major competitors, let's say. Certainly we don't have the highest interest rates in the world. Our interest rates are higher than they are in Japan and Germany.

Senator SARBANES. And it is from these countries that this foreign capital is coming, is that correct? In other words, it's being made available to us because we are paying a price for it.

Mr. ORTNER. Well, we are paying a return on that investment in the United States. To some extent, those investors are responding to interest rates that are higher in the United States than in their own countries. Possibly if they didn't buy some of the securities, the interest rates would be a little higher in the United States and, therefore, it would be helpful if we had some adjustments within our own economy and within our own financial structure.

For example, it would be helpful if we could get our budget deficit down. And this administration does want to do that and does want to control spending and reduce spending, where necessary, to accomplish a lower budget deficit.

Representative MCMILLAN. I have some figures that I think perhaps have been covered here, but at the end of 1986, 18 percent of all foreign assets in the United States were held by foreign governments. Presumably, those would tend to be in government securities would be my assumption; 16 percent of the foreign assets in the United States were direct investment in plant, equipment, and real estate. That is in fixed assets. And 23 percent of foreign assets were held in the form of stocks and bonds.

Probably the most volatile one of those might tend to be—certainly in recent days—those in the stock market. I don't consider foreign investment to necessarily be negative. It can be very positive. It depends upon why and the trend of it, and I don't think it's necessarily something that we should fear unless it continues to grow and we become increasingly dependent upon it.

Mr. ORTNER. I agree with you, sir. I think foreign direct investment is good for the United States and we should not discourage it. I think each case in that sense perhaps has to be examined individually, but that kind of investment is helpful.

Yes, certainly foreign companies investing in new plants in the United States will earn dividends or profits on that investment. But by the same token, they add to our production and they add to our employment, which I think I commented on before, and if it's healthy investment, then it is good for our economy.

Representative McMILLAN. Mr. Chairman, I think Mr. Ortner has got other matters and I have no further questions. Again, I apologize for missing some of your testimony.

Senator SARBANES. Mr. Ortner, I wish we could have you all morning, but I understand the demands on your time.

Just on this last point, the report that we issued last August—I commend this report to you, incidentally—indicates that the percentage of foreign assets in the United States that is in direct investment in equity has declined between 1970 and 1986 and the amount that's in debt has increased rather sharply.

It's not a bad point if you borrow money and use it for productive investment; that's a time-tested economic principle, is it not?

Mr. ORTNER. You said debt instruments—of course, corporations issue bonds to finance their capital projects.

Senator SARBANES. That's right, but that's a fixed charge we then have to pay, no matter how the economy moves, is it not?

Mr. ORTNER. The corporation will have to pay interest on that borrowing, no matter who buys the bonds.

Senator SARBANES. That's right. If it's a direct investment or equity, it will not have to. That rides with the economy.

Mr. ORTNER. It will pay dividends on that.

Senator SARBANES. If the economy goes soft, that burden is not there. If you shift into debt instruments, you're going to have to pay that burden whether the economy goes soft or not, are you not?

Mr. ORTNER. Yes. The interest payments on the borrowing are an obligation.

Senator SARBANES. Well, thank you very much, sir. We very much appreciate your coming and we look forward to having you back before the committee.

Mr. ORTNER. Thank you very much. I enjoyed being with you, sir.

Senator SARBANES. Thank you.

If Mr. Solomon and Mr. Marris, our two panel members, would come forward, we look forward to hearing from you. As I indicated at the outset, we are very pleased to have this panel with us. We have two very distinguished witnesses.

Mr. Solomon, now the chairman of the board of S.G. Warburg in New York, served in the late 1970's as Under Secretary of the Treasury and then from 1979 to 1985 was president of the Federal Reserve Bank in New York; and Mr. Marris, who for the last several years has been a senior fellow at the Institute for International

Economics here in Washington, before that served for almost three decades at the Organization for Economic Cooperation and Development, the OECD, in Paris.

Gentlemen, we are very pleased to have you here this morning. Mr. Solomon, why don't you lead off.

STATEMENT OF ANTHONY M. SOLOMON, CHAIRMAN OF THE BOARD, S.G. WARBURG, NEW YORK, NY

Mr. SOLOMON. Thank you, Mr. Chairman.

I am pleased to provide my views on the factors that lie behind the current instability in financial markets and my assessment of the kind of policy response that can help restore confidence in the period immediately ahead, and, at the same time, lay a foundation for restoring longer term balance in our global economic and financial relationships.

Right at the outset, however, I want to emphasize that the basic problems that have led to successive disturbances, first in the foreign exchange markets, then in the bond markets, and just recently in all the world's stock markets, have origins that are traced to many years of policy errors in the major industrial countries and to far-reaching economic changes of a structural character. Therefore, even if we do the things that are overdue to repair the present rupture of confidence, we still will be confronted with a long period—and by that I mean the better part of a decade—of adjustment, in which our economic prospects will be constrained and our growth retarded.

If we fail to act responsibly, then the outcome can be much worse. A severe recession could easily ensue and world trade could be subjected to serious contraction. Therefore, we should focus not only on the recent crisis, but also on how long-standing imbalances—in trade, government budgets, and national savings rates—have undermined the foundations of financial market stability.

To begin with, we must recognize that because of the absence of any serious effort to deal with these basic problems, the U.S. current account has become unfinancable by private capital flows. This year, net private capital inflows have virtually dried up. The whole offset has been through official capital, much of which reflected intervention in the foreign exchange markets. Investors know that this cannot be maintained indefinitely. However, they have no way of knowing how much support the main central banks will be willing to provide. Consequently, they have no way of knowing whether the next burst of selling of the dollar, or the one after that, will be countered by official intervention operation.

These concerns heavily weigh on our domestic bond market. Just the threat of foreign selling of bonds has precipitated repeated declines in the bond market, forcing U.S. long-term interest rates higher and causing large losses on the part of the dealer community.

For several months, the stock market tended to brush aside these concerns, focusing instead on the outlook for rising corporate earnings, which had been reasonably bright. However, an undercurrent of concern began to develop even in stock markets as the summer went on, and by the time of the patently unsuccessful IMF meetings in Washington late in September, the equity investor was also becoming extremely nervous. It is not an oversimplification to say that the historic plunge in the stock market basically reflects a growing lack of confidence in the ability of the United States and its major allies to come to a compromise on reducing international imbalances and in the ability of the U.S. Congress and administration to forge a compromise budget.

Although the precise details of these financial shocks could not be predicted, the handwriting was on the wall for some time. As some of us have argued, it was unlikely that the political determination to deal with the underlying problems would be forthcoming unless there was a financial crisis. It was easier simply to let the problems fester.

Now the shock has hit. What shape should the policy response take to come to terms with the immediate situation?

First, we still have a massive trade deficit despite a sharply lower dollar. Many academic economists as well as a few government advisers are convinced that a further sharp drop in the dollar is needed. I am skeptical. The causes of our trade deficit are complex. Exchange rate misalignment was only one of a number of causal factors. Excess demand in the United States is now clearly responsible for continued strong import growth. Another sharp drop in the dollar will translate quickly into more inflation and higher interest rates. We will probably see persistent downward pressure on the dollar for some time. And so some dollar decline is probably unavoidable. But to seek a sharp depreciation at this point is highly questionable, because it would be almost certain to rekindle another disturbance in the financial markets. In any case, to get the maximum benefits for the trade position from the lower dollar than are presently coming through will require a substantial shift in resources into the tradeable goods sector.

The case for accommodation has been greatly strengthened by the worldwide stock market fall. This has dealt an enormous deflationary impluse on the global economy. Unless those who are in the position to ease their monetary policies do so, they may unwittingly contribute to triggering a global recession. Under those circumstances, no country will be spared and no lasting improvement in the U.S. trade deficit will be possible either.

A U.S. budget compromise is essential to the restoration of some degree of confidence, not only in the stock market, but in the economic outlook more generally. There need to be cuts in spending that are meaningful and permanent. There need to be increases in revenues that go beyond a single year's budget; thus, expedients such as asset sales which cannot be expected to be continued ought to be viewed with skepticism. I would not want to suggest any particular amount by which the budget should be cut or any precise figure for revenue increases. But anything less than at least $25 to $30 billion in the first year of a multiyear program that builds on that by $15 to $20 billion each year after that would most likely be seen as highly inadequate by most participants in the financial markets.

It is important to produce budgetary cuts that will allow the Federal Reserve to encourage lower interest rates. But do not be under any illusions: the economy now is expanding faster than is desirable or sustainable over the longer run. Stimulus on a net basis is not justified. What needs to happen is for resources to shift from domestic demand to exports and import substitution. That has been difficult to achieve under conditions of accelerating real growth. But it can be achieved, albeit at a gradual pace, under conditions of more moderate expansion.

Even with a meaningful budget package, maintaining confidence in the dollar will be exceedingly difficult, even more so because the devaluation argument seems to be spreading. The key will be to encourage monetary stimulus on the part of those countries with low rates of inflation and strong current account surpluses, but to recognize that excessive stimulus will be rejected out of hand because inflation fears still prevail.

Is there any prospect of reaching such an agreement with Germany, which has so far been most reluctant to adjust its policies? It is hard to be optimistic. But if Germany continues to refuse to do what is in both its own interest, given the continued high level of unemployment and low growth rate there, and in the interest of better international balance, then I doubt that it will be possible to avert further downward pressure on the dollar against the mark. I suspect that German officials are aware of this fact, and that they will carefully weigh the relative costs and benefits of a policy stance that may accentuate downward pressures in their overall economy.

What is the best that can be hoped for realistically?

The United States has just about run out of leverage. Most policies that would seem to put pressure on other countries to act, such as the trade bills now before congressional conference committee, actually will make us substantially worse off. They may even cause a global downtown that will rival the worst of previous slumps. They would permanently undermine our leadership role in the world.

About the best thing we can hope for is that efforts to fashion a significant budget compromise will give enough weight to the argument for policy change in the surplus countries to compel a positive response from them. But even if stubbornness prevails, we have to do that in our own interest. Inflationary pressures are now subdued; the fall in the stock market and the deflationary shock associated with that will delay their reemergence. But the real economy does not have much excess capacity, and some day the inflation threat will come back strongly. Only a much reduced Federal budgetary position can give reassurance to financial markets that we can parry that threat effectively.

But there should be no misunderstandings. Even with the best feasible policy response today, it is hard to envisage an improvement in our trade position sufficient to bring down the nominal deficit much below $75 or $100 billion on a structural basis. That is, abstracting from any recession that may develop next year or the year after that. This deficit, like the present one, will have to be financed by inflows of capital from abroad. This likelihood will tend to leave the dollar, in my view, persistently vulnerable in the exchange markets. Thus, the dollar will be chronically weak, and the absolute need to keep financing a persistent structural trade deficit will predispose the Federal Reserve to err on the side of a tighter monetary policy to prevent a disastrous freefall of the dollar. This will impede rapid growth in the U.S. economy. And so will the terms of trade induced weakness in U.S. consumer income growth, which is an unavoidable byproduct for a chronically weak dollar. At the same time, our consumption as a nation will have to be curbed so that we can continue to service the debts that we will run up to cover the trade and current account imbalance.

In a word, without economic expansion in the surplus countries that is far greater than what they seek and what they believe is compatible with their low inflation, our growth—in income and in consumption—will be retarded. That is the price we will pay for nearly a decade of overconsumption. But if we fail to put right the basic causes of our trade imbalance—the Federal budgetary deficit, most prominently—the outcome will be far worse: continuing financial instability, a big recession, a collapse in world trade, and the likelihood of no growth at all for a long period of time. The world's financial markets have issued a clear warning that major policy initiatives are needed. There is no excuse to delay anymore.

[The written supplemental statement attached to Mr. Solomon's oral statement follows:]

WRITTEN SUPPLEMENTAL STATEMENT OF ANTHONY M. SOLOMON

Mr. Chairman, when you asked me to participate in this discussion of the international economic and financial situation, it occurred to me that it might be useful to supplement my testimony by submitting a written statement that outlines my views before the recent turmoil in the world's stock markets in order to provide some perspective on the origins of our current problems.

At about the time of the Venice economic summit this June, I had the opportunity to address a group of experienced financial market professionals about the issues that form the topic of this hearing. In a nutshell, I argued that financial market disturbances were becoming progressively more severe and that the leaders of the United States and our allies needed to do a far better job of harmonizing national economic policies in order to have any chance of restoring greater stability to the markets.

Unfortunately, the opportunity to act constructively was not seized, and the conditions in which the stock market crash eventually occurred were permitted to develop. Here is that analysis:

This year hardly anyone needs reminding about the impact of international factors on our economy and our financial markets. The continued erosion of the value of the dollar against other major currencies was enough all by itself to galvanize attention on the global perspective. It is reminiscent of the atmosphere we faced back in 1978, when the dollar also came under assault. But this time round, the day-to-day behavior of the bond market, and often of the stock market as well, has had a much clearer international dimension than in 1978. We have all become aware of persistent concerns over whether foreign capital will continue to flow into the country in the amounts needed to finance our massive trade and government budget deficits, at least without the attraction of substantially higher yields on dollar assets.

In that context, the sudden disturbances in the financial markets during March and April have had a sobering effect on practitioners and observers alike. The turmoil brought home in a concrete way just how interrelated the various pieces of the globalized financial system have become and how quickly a shock can be transmitted from one market to another. And it's instructive that the source of this financial market episode was something entirely out of the ordinary: an action from the province of international trade policy, namely the imposition of tariffs on Japanese electrical products in retaliation for alleged infractions of last summer's semi-conductor agreement.

It is one of the very rare times in my memory, perhaps the only time, in which a protectionist action caused a major adverse impact on financial markets. But it should not be too surprising that the issue of protectionism should now be capable of influencing the dynamics of interest rates and exchange rates. Any action that potentially exposes the world to an escalation of measures and counter-measures, each relatively modest in impact, but collectively posing a grave threat to the trading system as we know it, should have a profound effect on market psychology. After all, the danger of a revival of inflation has never been far beneath the surface and international investors are mindful of how trade restrictions can quickly result in anticipatory price increases and a rapid escalation in inflation rates, even in an underemployed economy.

Thus, the market disturbance of March and April was serious enough to compel some immediate response by the monetary authorities, and they did step in with considerable *intervention in the foreign* exchange markets. Frankly, some people would dismiss this as merely a tactical response, and there is something to that criticism. But when effectively implemented, such tactical responses do some good. They can restore a degree of orderliness in the foreign exchange markets and indirectly settle the bond markets somewhat. In the recent case, though, the central banks went a step further. They confirmed that interest rates were being adjusted to curb the sharp fall of the dollar.

Naturally, many are asking whether these actions signify a shift toward greater coordination of monetary policy, and if they do whether that will be sufficient to restore stability to the major financial markets, here and elsewhere.

My own analysis is that the actions in the monetary area, while useful, have been essentially designed to buy time until the broader economic policy debate, which essentially turns on questions of taxation and fiscal policy harmonization, can be resolved by the top government leaders of the key industrial countries -- either at Venice or afterwards.

Basically, they -- the government leaders -- are confronted by a complicated situation at the present time. Intellectually, there has long been an obvious need for the US to make sizable cuts in the federal budgetary deficit in order to reduce the gap between domestic savings and investment which now necessitates large-scale capital inflows to close. Foreign governments have been pressing for such a pledge from the US for years, with little to show for it.

But in certain respects the US expansion is showing signs of age. No one can rule out a period of slow growth or even a mild recession in the next year or so. Under those circumstances, budget cutting becomes risky in terms of its potential macro-economic effects, without appropriate stimulative actions by the governments of the countries with large trade surpluses and low inflation. But there is hardly any consensus on what the real options are for governments who analyze the world from drastically different vantage points and ideological perspectives and who have different political timetables, as well.

As a result, as a practical matter, the US, and particularly the Federal Reserve, is faced with a difficult balancing act. How do you balance the needs of the domestic economy with the requirement of having to attract sufficient inflows of foreign capital to finance the US current account deficit, to indirectly finance the federal budgetary deficit, and to maintain a reasonable degree of stability in the domestic bond market and the stock market, as well as in the exchange markets?

My own analysis of that central question proceeds from a couple of premises. First, I take for granted that the dollar is likely to remain, more or less indefinitely, under the threat of selling pressure from time to time so long as this country continues to have a sizable trade deficit. Nothing that has been done so far, either in terms of the fall in the value of the dollar or in terms of economic policy changes here or abroad, can alter the trade pattern enough over the next, say, two or three years to remove that danger, Consequently, there will be repeated confidence tests, ongoing concern about what is likely to happen to inflation in the US, and continuing anxiety over US monetary and fiscal policy.

I also take as a starting point the special perceptions held abroad about policy options and constraints. Most important are the perceptions in Japan and Germany, and my judgment is that the two countries view their situations in fundamentally different ways.

Japan would like to run large current account surpluses, but recognizes that the rest of the world will not permit it indefinitely. Thus, to restore some semblance of balance in its external payments it has a fundamental restructuring problem every bit as complex as the one confronting the US. There is even a broad degree of consensus among the Japanese establishment about what needs to be done over the medium term to effect that restructuring: namely, it must be based to a very large extent on an ambitious housing program. But in the immediate situation there are enormous obstacles, in terms of agricultural policy, capital gains treatment of property sales, and antiquated zoning laws, that stand in the way, either by driving land prices up to astronomical levels or by perpetuating uneconomic urban land use.

Some day, these obstacles will be relaxed, but not until considerable political costs have been incurred. In the meantime, short-term economic management is gradually becoming more constructive. The authorities perceive they have relatively limited scope for bringing down interest rates further, from levels they feel are almost rock-bottom. But there is some willingness on the part of the Nakasone government, (supported now by a fairly widespread consensus in Japan), to take some risks in the direction of greater fiscal stimulus. It is particularly revealing that despite the failure of his tax reform initiative, Nakasone was still willing to include some tax cuts in the recent budget expansion program. Whether that program will be sufficient to give much of a boost to domestic demand and generate greater import volume, from the US or from other countries, can't be clear as yet. But the Japanese have shown that they do not have an ideological aversion to seeking coordinated policy options and are capable of some action.

In Germany, which is key from a European perspective, the perceptions of what can and should be attempted in terms of both short and medium-term economic management are more stubbornly held. There is no consensus about restructuring the German economy; that reflects an ambition to maintain an ample current account surplus more or less indefinitely. Despite the free market rhetoric lavishly put on display by German officials, moreover, there is hardly any enthusiasm for initiatives that could help insert a greater degree of competitiveness into the telecommunications industry or in more prosaic industries like retailing.

As for short-term management, up until recently, at least, the belief has been that German policy is appropriate; that economic growth now being attained, even though it is slower than predicted some months ago, is satisfactory; that the direction of fiscal policy is correct and should not be substantially eased; and that Germany bears no particular responsibility for helping the US cure its home-made problem of a large trade and current account deficit. Thus, while on the face of it, Germany ought to be in a better position to contribute to a coordinated policy, even if only on a tactical basis, the willingness to do much more than occasional intervention in the foreign exchange markets has been undetectable.

The implication is clear. Unless there are major changes in attitudes, the US is not going to get that much help. So the short-term policy dilemma basically boils down to the question of whether the Federal Reserve will be willing to risk a recession in the US in order to stabilize the dollar the next time the confidence of foreign investors is shaken.

I wouldn't want, in any case, to exaggerate their ability to avoid a recession, however. While hardly any economists are now forecasting one, the economy is still plagued by obvious weaknesses. Business investment has fallen. Construction is weak in many parts of the country. The stimulus from loose fiscal policy is wearing off. The consumer is spending, but more carefully, and there are signs of concern about the outlook, which could easily translate into decisions to increase appallingly low levels of precautionary savings. Plus, higher interest rates are already threatening housing.

So the only real chance of a resumption of strong growth of final demand depends on net exports improving. There has been some improvement, but it is disappointingly slow and now is jeopardized by renewed concerns about the financing ability of the main LDC debtor countries. Without good export expansion to Latin America and a few other LDCs, it is hard to foresee anything but a very modest improvement in the US trade position.

Thus, it may be too late for monetary policy to avoid an accumulation of other weaknesses leading to a recession, presumably a mild one but enough of a slowdown to cause some serious side-effects in the financial positions of many overleveraged companies. And even if it is not too late, it may be that the need to provide support for the dollar in the exchange markets will make it impossible for the Federal Reserve to respond to any weakening of the domestic economy.

Perhaps it would be useful to review the facts regarding the foreign financing of our current account deficits, facts which are not always adequately appreciated. The US started to run large current account deficits only in 1983, but since then of course they have multiplied dramatically. Looking at the financing historically, it's probably worth dividing the period into four phases, even though they overlap.

In the first phase, in 1983 and much of 1984, the current account deficit was basically financed by the banking system and the primary motive was that profit margins were greater in the US than in the Eurodollar market. In effect, the sharp swing to a loose fiscal policy gave a strong boost to domestic demand. Then the rapid economic recovery created large demands for private credit on top of the federal government's demands, at a time when opportunities to lend abroad had drastically contracted. Eventually, the pressures led to a rebound in US interest rates, which the Fed encouraged so as to avoid an overheating of the economy. That drew further inflows of short term funds from abroad.

In the second phase, you had a unique combination of factors that all magnified the apparent attractiveness of investing in dollar assets. Fiscal policy was still providing stimulus to the economy, but the recovery was slowing down, and credit demands were slackening. Inflation was continuing to ease, and markets were convinced that the Federal Reserve would give highest priority to making that stick. Credibility was never higher for our central bank. So long term bond rates declined, and foreign purchases of bonds took over from banking system flows as the single most important financing offset to the current account deficit. The attraction of a rising dollar and a rising bond market, which generated capital gains, actually led to a situation in which the current account deficit was overfinanced.

The world began to change following the Plaza Agreement. It triggered a major adjustment in expectations, but most of that adjustment was centered on what would happen to the dollar's exchange rate. Little had to do with what would be the implications for US interest rates. And of course, the drop in oil prices kept inflationary expectations in check. So even though the dollar retreated, there was a steady stream of foreign private capital into the US. However, during 1986 the composition of the flow began to change. Real estate and common stocks emerged as important components, reflecting the belief on the part of the many foreign investors that the bond market was near its peak prices, and it was sensible to diversify.

During this third phase, something else began to become apparent. Americans were beginning to move out of dollars into foreign assets. We were having to finance not just a current account deficit but some $40-50 billion of capital outflows, too. Now when this happens in an LDC, it's called capital flight and we read a lot of sanctimonious articles expressing moral indignation that the residents of a country could react to their government's policies in that way. We don't use the same term to describe what Americans have been doing, but it boils down to the same motivation. In the absence of an effective strategy for dealing with the federal budgetary gap and for getting other governments of surplus countries to stimulate their economies, the attraction of assets in other currencies has become irresistible to many US investors.

The flip side was that more and more official purchases of dollars have become necessary to finance the current account deficit. And in the fourth phase of the process, which roughly coincides with this year, virtually all of the deficit has had to be offset by foreign official dollar acquisitions, whether through outright intervention in the exchange markets or through other official transactions.

At first, as pressure on the dollar intensified and official intervention swelled, there was little apparent impact on US long term interest rates. The slowing in the US economy and the residual good feeling about inflation prospects provided a buffer, temporarily shielding the bond market from the adverse impact that otherwise would have occured earlier as a result of diminished foreign demand for dollar securities.

All that changed after March 26. In the subsequent month we experienced one of the sharpest collapses in the bond markets ever, rivaling the worst weeks of 1979 or 1982. Hundreds of millions of dollars of losses were absorbed by the dealer community. Wounds were inflicted that will not soon heal.

In retrospect, there are those who say that the near seizing up of the market could not have been predicted. But many danger signs were clearly present.

First were the conflicting signals we had been getting throughout the winter from the stock market on the one hand and the bond market on the other. From January until nearly the end of March we witnessed one of the most dazzling rallies in Wall Street history. Behind it was the growing view among both analysts, who have been wrong on this before, and investors, who are generally more cautious, that US corporations were going to see a strong rise in earnings, even with the economy as a whole growing only at a moderate rate. There were several reasons: cost containment efforts were finally bearing fruit; the initial impact of the new tax reform law was unexpectedly favorable for a large number of companies, and large drafts on earnings from previous write-downs were behind most corporations.

But perhaps the key factor was the belief that the lower dollar would be good for profits. To begin with, there was the standard improvement in the offshore results of multinational companies when translated back into dollars. Beyond that, the lower dollar is thought to provide an umbrella under which companies could raise prices more easily. Thus, domestic profit margins would increase accordingly. In other words, the early phase of a pick up in inflation (that is, before higher prices provoke bigger wage demands) was thought to be favorable for profits and stocks.

The bond market (along with any number of economists who were predicting little or no rise in inflation) shrugged off the inflation warning. Movements in bond prices were the smallest in a decade. It was merely assumed that foreign investors, primarily the Japanese, would step in whenever yields rose 15 or 20 basis points and that led to a false sense of security that a build up of bond inventories was virtually risk free. Even the renewed decline in the dollar did not immediately dislodge those assumptions.

It took a shock to arouse the market, and in the process, to expose one dangerous fallacy, i.e., the belief that foreigners have no place to go other than to hold dollar assets. To the contrary, not only foreign investors, but increasingly US investors also, have discovered a rich array of alternatives. Thus it will take real policy changes to rebuild lost confidence in investing here rather than someplace else. How is that to be done?

It seems to me that the options most frequently talked about fall into three broad categories.

First, a few people, mostly academics, but some market participants as well, argue that you cannot keep attracting large-scale inflows of foreign funds unless the dollar is drastically devalued to such a low level that it would be virtually a sure thing for the next movement in the dollar rate to be up. Since the same people usually maintain at the same time that a further sharp drop in the dollar is both necessary and sufficient to produce a substantial reduction in the US trade deficit, they want to get the so-called 'inevitable' out of the way quickly. They say absorb the inflationary consequences now, while inflation is still low, and head off the risk of a worse scenario, one in which the dollar continues to fall and US interest rates continue to rise. That could cause simultaneous recession and inflation.

This is a superficially attractive line of reasoning. It's true that there has to be some probability of a dollar rise to attract foreign investment, unless yield differentials are exceptionally wide. And it's also true that if the current account correction could and should be produced solely through exchange rate changes, it is better to get it out of the way reasonably quickly.

But in my judgment this kind of deliberately devaluationist approach will not work. Yes, a drastic further fall in the dollar can be orchestrated, but it would not by itself eliminate the trade deficit. Plus there are enormous disadvantages. It is highly inflationary at a time when other sources of inflation are clearly emerging. It would kick off financial panic, with a huge rise in interest rates. And whatever the decline in the dollar that this orchestrated strategy produced, there would be large numbers of foreign and domestic investors who would be skeptical and would prefer to test the new levels. So it is unlikely to rebuild any sense of confidence or stability.

What's worse is that it is based on another dangerous fallacy: that all we need to get the trade and current account back in balance is for the dollar to fall enough, where 'enough' is defined as some further decline from where you are at the moment. I personally don't buy the premise. I think that there is no single value of the dollar, however low, that will cure our trade problems, because long before the economic effects would be able to come through, the whole nature of the international trading system will have been changed. Governments abroad will simply reject whole industries being bankrupted, and large numbers of workers dislocated, just to achieve the dubious goal of eliminating the US trade deficit. It will not be allowed to happen that way.

So the first strategy is both risky and unlikely to work. There is a big difference between acquiescing to a lower value of the dollar, which I suspect we may have to do, and seeking a further decline. It is going to be difficult enough to cope with the dollar trend, without unleashing adverse forces which could easily lead to a collapse of confidence and a free fall for the dollar.

The second broad option is to urge the Federal Reserve to undertake an overt tightening of monetary policy to engineer sharply higher interest rates, thereby generating market expectations that the next move in interest rates will be down so that there is a powerful motivation to buy bonds. It is similar in spirit to the first option, but it calls for the overshooting to occur in the bond market rather than in the exchange market. It has the advantage of being a decisive anti-inflation policy. And if the Federal Reserve is lucky, it might find that efforts to drive up short-term rates sharply would only partially spill over onto the longer term rates, and thus would temper the adverse consequences of the strategy for the economy.

If the economy were already showing unmistakable signs of overheating, then it might be worth taking the risks of this forceful approach. The danger is that the economy is now too weak to withstand an overt tightening of US monetary policy. It could tip the economy into recession, which would be aggravated as the debt problems of many companies and countries led to financial disarray. Thus, it is not a sensible approach at this time.

But more to the point, to cure the current account deficit by deliberately engineering a recession is not going to be acceptable politically. Enough said.

The third broad option is the best solution, but it involves changing deeply held views in Germany and to a lesser extent in Japan. And it involves the even bigger hurdle of changing the US Administration's opposition to tax increases. It boils down to major fiscal policy modification, with substantially larger tax cuts abroad than planned and tax increases in this country as part of an overall budget reduction program. The impact would be highly stabilizing for financial markets. US interest rates would go down; other's would go up. But the positive effect on the inflation outlook, as well as on the perception on the part of foreign investors that the US had finally gotten its act together and was now embarked on a sensible fiscal policy tack, would stimulate foreign inflows. So the dollar would not weaken and could actually firm a little.

Naturally, there would be some benefits even if the US acted alone. But the positive impact is far greater when this strategy reflects a collective action. In that case, the protectionist threat would be reduced materially.

Now, it is perfectly true that I am among those who have long been urging some form of collective, harmonized policy shift to come to grips with the eventually destructive combination of unbalanced world trade, inadequate growth, and large budget deficits in the US. And virtually nothing has been done. Should we be more optimistic now? I doubt it. It's probably true that without some shock, like the bond market collapse that we experiences a few weeks ago, it will not be possible to focus the attention of top government leaders on the need to do anything. Thus, improvisation is likely to continue, tactical responses will be forthcoming, but the basic problems will not be resolved. That kind of situation could go on for some time, with the net impact being a long term downward tilt in the dollar and a long term tendency for US interest rates to be higher than would be desirable from the point of view of domestic growth. It will also mean continuing sluggishness in Japan and Europe, continuing trade frictions with them, as well as with the Asian NICs, and perhaps the passage of some sort of protectionist legislation by the US Congress that will invite retaliation.

To borrow a nasty image, there has been something like a balance of terror existing in economic policy terms in recent months. Japan and Germany can just about force the US into an early recession by doing nothing, contributing nothing to a pro-growth package, or even terminating the modest tactical support they have been providing. At the same time, the US can seriously harm large segments of Japanese and European industry either by going in a protectionist direction or by orchestrating a new round of sharp declines in the dollar.

Here is where I believe the existence of economic summits is vital, even though I recognize that the track record of past summits has been at best erratic. Only two previous summits have yielded concrete agreements that implemented a program of specific measures and thus represented a meaningful coordination of economic policies. Those were the summits at Rambouillet, which initiated coordination in the international monetary field, and at Bonn in 1978, where a whole host of measures were fused into a package that led to a significant liberalization of US energy policy and a macro-economic initiative by others that set the stage for eventual adjustment of the growing US trade imbalance at the time.

The second category were those summits which, while falling short of the ambitious goal of implementing concrete action, nevertheless succeeded in influencing the thinking of the heads of government in important and useful ways. I am mostly familiar with the London summit of 1977 and the Tokyo summit of 1979 as examples, but others would probably cite the recent summits that gave momentum to the desirable trend toward privitization of activities that are best carried out outside of government.

In the third category were those summits which neither influenced thinking nor yielded specific agreements. Even they were not complete failures in that they were better than nothing. Why? Because even those summits have positively influenced more modest attempts at coordination at the ministerial level, whether within the context of the OECD, the IMF, the G5, or other such bodies. Even with no meaningful policy commitments, the summits have left behind language which has a beneficial psychological effect on cabinet level officers who are aware that their boss is more knowledgeable about the issues and the options as a result of the summit preparation process. This is a beneficial, practical outcome, in political and bureaucratic terms.

In terms of subject areas it's clear that when publics of the various countries perceive the subjects as being instrinsically 'international' in content, they are more willing to accept an attempt to coordinate policy. The areas of trade and foreign exchange rates fall into that group.

But the most difficult subject to get public opinion to see as a legitimate object of international discussion, let alone negotiation, is that of fiscal policy, especially taxes and government spending priorities. These are naturally viewed as nationally grounded and even the most sophisticated are reluctant to yield authority over these matters, even as part of a mutually beneficial negotiation.

Today's summit comes at a complex time when the issues span all of these difficult topics. It will take wisdom and a considerable willingness to deviate from strongly held prior positions to reach a mutually beneficial deal. Prospects for such a deal are poor. At this time the more likely outlook is that only a worsening of the global economic situation, or a change in potential leadership in the U.S., will improve those prospects for a future deal.

* * *

As it turned out, the summit was widely judged to be thoroughly disappointing. Market pressures had receded, the likelihood of renewed financial crisis seemed remote, and the short-term economic outlook was improving somewhat. There were even a few tentative signs of improvement in the U.S. trade position. Consequently, any sense of urgency that might have impelled a collective response was collectively lacking.

But by the middle of August, the situation had deteriorated badly. The trade figures soured. Inflation prospects appeared to worsen as the U.S. economy started to pick up tempo. There were doubts about the priorities of the authorities in terms of controlling potential inflation. Thus, the dollar came under renewed selling pressure and the bond market weakened further as once again there were questions raised about the sustainability of inflows of foreign capital.

As interest rates began to climb, the stock market peaked and quietly began a decline that would reach truly monumental proportions within the space of merely six weeks.

Now policy makers are talking, at least in Washington. But they should ask themselves whether such a horrible price had to be paid to dislodge the complacency, reticence, or intransigence that had characterized much of what came before.

Senator SARBANES. Thank you very much.

Mr. Marris, please proceed.

STATEMENT OF STEPHEN MARRIS, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. MARRIS. Mr. Chairman, this session you wanted to devote to the longer term trends in U.S. trade and external debt position. However, with your permission, I'd like to devote at least the major part of my remarks to what has happened in the last 2 weeks and what is likely to happen in the next few weeks because, in my view, that is actually very largely going to determine the longer run outlook.

To my mind, there is no mystery about what happened on Wall Street. As Tony Solomon has just said, the United States has been living beyond its means for several years. It's been spending more than it's been earning to the tune of about $150 billion this year. That is about $2,000 per household.

Now what happened on Wall Street was part of the mechanism by which the "magic of the market," to use President Reagan's phrase, is going to force American spending back down in line with its income.

Unfortunately, absent major action to cut the budget deficit, if this process is left entirely to market forces, it will almost certainly lead to a recession in this country which will spread out through the rest of the world economy.

Now, of course, for so long as foreigners were willing to lend massive amounts to the United States there was no problem, but it was foolish to think that this would go on indefinitely. Once the dollar began to come down, foreigners were exposed to massive exchange-rate losses and, indeed, as Tony Solomon pointed out, by the beginning of this year, the world's foreign private sector stopped lending to the United States.

I was slightly surprised to hear the Under Secretary for Economic Affairs from the Department of Commerce suggest that there was in fact any private individuals in the world lending net to the United States at the present time. That's stopped.

Now you may ask how is that the case? We've seen that the Japanese are still buying up shopping malls in Washington and real estate in California and in a much publicized fashion buying government securities at Treasury auctions.

What the overall figures are telling us is that while that was the case, somebody somewhere else in the system, whether they be Japanese or even Americans, were going the other way. They were moving out of dollars into yen or into marks.

And the result, Tony Solomon said, is that since the beginning of this year, it is the world's central banks that have been financing the U.S. trade deficit directly and in fact indirectly they have been financing the U.S. budget deficit more or less completely during the course of this year.

They have been doing it, of course, simply by printing money. In order for them to buy out the excess dollars on the world's foreign exchange markets created by the U.S. budget deficit, they simply had to print yen and print marks in order to buy up the dollars.

Now that couldn't go on indefinitely either because obviously it was creating inflationary potential in those countries. So that by the beginning of October at the time of the annual meetings that Tony Solomon referred to, three things were becoming clear.

One was that the drying up of the inflow of private capital into the United States was ratcheting up the whole level of world interest rates.

The second was that the central banks were trying to sustain the dollar, defend the dollar at what was over the longer run an unsustainable level.

And the third was that the central banks would not be able to continue to do that indefinitely because of the inflationary potential of the money they were printing.

As Tony Solomon said, while this had become evident in the bond markets and foreign exchange markets of the world, the stock markets were still booming.

Really what happened 2 weeks ago was that the stock markets of the world realized that they were wrong and the bond markets were right. Therefore, all over the world, people have been shifting out of stocks into bonds and into the money market.

Now what happens next? Right now the stock markets are trying to find a new more realistic level in relation to the bond markets. That's why I think we keep seeing them going up and down. They don't quite know where that new level is.

Let's hope that they find that fairly quickly, but we must realize that once they do, we shall be back to where we were 2 weeks ago, which is, we are faced with the question, who is going to lend $10 to $15 billion a month to the United States, and next month and over the months to come, to finance its trade deficit?

Now it has become clear throughout the world neither the world's foreign private sector nor the world's central banks can continue to do this on the present scale. So what we shall see is new downward pressure on the dollar, new upward pressure on U.S. interest rates, and I'm afraid very likely a new slide on Wall Street.

Now, of course, this slide on Wall Street is the second mechanism—a rise in interest rates was the first mechanism. The fall on Wall Street is the second mechanism which is going to force U.S. spending down in line with its income.

Americans have made capital losses of around $1 trillion since August 25 and it will be surprising if they don't start to spend less and save more. The cost of equity capital has risen sharply. The prospects for the economy have worsened. It would be surprising if we didn't see that the recent rather encouraging pickup in investment began to tail off.

In other words, we will see the painful process by which U.S. investment will have to be brought down in line with the inadequate level of domestic savings in this country.

Now there is, of course, a much better way of doing that—by cutting the budget deficit. And I think it now is time to talk about the numbers. How much of the budget deficit to cut?

Well, there are two ways of trying to answer that question. The first is in terms of economic arithmetic and the other is in terms of market psychology.

The economic arithmetic is very simple. The United States this year will, one way or another, have to borrow $150 billion from abroad. If the United States is to stop borrowing from abroad for a while, which I believe it should and which I believe foreigners will force on it, then the budget deficit will have to be cut by $150 billion. Now that doesn't have to happen overnight. Indeed, it would not be right because the elimination of the trade deficit will take some time, but basically I would argue that the economic arithmetic tells us that the U.S. budget deficit should be cut by $150 billion from where it is now. That is to say from the $150 billion that it came out with in fiscal year 1986, that is to say that the budget deficit should be cut to zero over the next 3 years.

The market psychology and what it needed is a much more difficult question because there's one lesson we have learned from the experience of other countries—and for my sins, Mr. Chairman, I have seen this kind of situation develop in other countries too many times—and one of the lessons we have learned is that if the first package of budget cuts that you produce is not big enough in the eyes of the market, the next time around you have to double the figures. And if you don't get it right that time, the next time around you have to double the figures again.

So the crucial issue is how much is needed right now to restore confidence in the markets? In my view, that probably is something of the order of $100 billion cuts in the budget deficit laid down over a 2-year period. In other words, the budget deficit looking 2 years out from now should be running at no more than somewhere around $50 billion.

Now I am very aware that many of my friends among the American economists are taking a rather different line and they are arguing that anything more than a fairly small cut on the order of the $23 billion now being discussed would be a mistake because it would put the economy into recession.

Now what they fail to realize is that once foreigners lost confidence in the United States and decided that they were no longer prepared to lend money to the United States, a slowdown, if not a recession, in the U.S. economy was inevitable because, as I've said, American spending would have to be cut back in line with American income.

The only issue now is how severe that slowdown will be. What we have learned in Europe over the last 10 to 15 years is that you can get into a position where you need to turn Lord Keynes on his head. The Keynesian will say, "You should not cut the budget deficit if the economy is going into recession. On the contrary, you should increase it."

But what we have learned is that you can get yourself into such a mess—and, with respect, this country has got itself into a mess—in which the confidence building effects of decisive action to cut the budget deficit and to lower interest rates which that makes possible will at least over a period of a few months give more boost to the economy than the inevitable negative effects from lower government spending or higher government taxes.

Now the classic example of that comes from my own country. It was Mrs. Thatcher who in 1981 introduced a budget at a time when the British economy was already in recession. She introduced a budget which cut the budget deficit by 4.5 percent of GNP. If you scale that up to the present size of the U.S. economy, that was a budget cut of about $250 billion.

The result was that 365 economists wrote a letter to the Times of London saying that she had committed economic suicide.

Now if you go back and look at the figures, you will find that the recovery in the British economy dated from the very quarter in which she introduced that budget and that, indeed, that was the turning point in the British economy. Since then it has been recovering slowly but fairly steadily.

Now there were some differences in the situation then than there are in this country now, but there are also some similarities. The main reason why the British economy began to recover quite quickly was that the pound came a long way down and the positive boost that the British economy got from the lower pound was enough to offset the negative effects on domestic income from cutting the budget deficit. This is exactly what Tony Solomon was saying has to happen here, and there was a classic example where this happened.

And here, of course, there is one very positive factor in the U.S. situation, and that is that the dollar has now been down far enough for long enough to, as Mr. Ortner said, be already giving a significant boost to the U.S. economy.

So, in my view, to sum up on this, if decisive action is now taken to cut the U.S. budget deficit and to convince both the domestic financial markets here in the United States but, above all, foreign investors throughout the world that the United States is now going to take decisive action to cut its budget deficit, then there is no reason why we should not see only a moderate slowdown in the U.S. economy next year, a fall in interest rates, a fairly short slowdown, followed by in fact a very strong recovery because interest rates will be down and exports would be up.

Now I'd like to turn very briefly to the dollar and to monetary policy. I very much agree with what Tony Solomon said here, and I have to say that I strongly differ from the views expressed by three distinguished economists before the House Banking Committee yesterday—that's Herb Stein, Marty Feldstein and Kenneth Galbraith—at least as they were reported in today's Washington Post. I haven't had the opportunity to actually read their testimony.

What they are reported to have said is that, given the crash on Wall Street, the Fed should now concentrate exclusively on providing adequate credit to the domestic economy and should just let the dollar go.

Now I know what the logic of that position is. It is that if the dollar falls to the right level, foreigners will say, "Well, it's now at the right level. It's not going to fall any further. And so it's safe to start lending to America again."

Now the point they are missing is that until we know how long it is going to take this country to take decisive action on the budget deficit, nobody knows how far the dollar is going to fall. It's going to have to fall. Indeed, in the absence of effective action on the budget deficit, the decline in the dollar could well get out of control.

What that means is that the Federal Reserve Board is going to have to pay just as much attention to what is happening in the world's foreign exchange markets as to what is happening on Wall Street. And the problem is that the two markets will be looking for opposite signals. The domestic financial markets will be looking for a signal that the Fed is prepared to pump credit into the economy. The foreign exchange markets will be looking for signals that the Fed is prepared, if necessary, to let United States interest rates rise if the dollar is under pressure.

The Fed is indeed in an impossible position. We must hope that it will try and steer a course between that, but in fact it can only do a holding operation until something is done about the budget deficit.

To put it together in an overall sense, what we need is a package, and international package, which includes a program to eliminate the U.S. budget deficit, which includes agreement by Germany both to pursue a very expansionary monetary policy but also in my view also to give itself a dose of fiscal expansion, and third, we probably do need a lower dollar. But to try to devalue the dollar now without the other two elements in the package, is a recipe for disaster.

Let me just now turn to the trade deficit. I want to undermine the good news that Mr. Ortner gave. I was in fact rather worried when I saw in the newspapers the third quarter GNP figures because they show actually a small drop in net exports in volume terms, but when I looked at them in more detail I find that that is entirely due to the rise in oil imports and that in fact if you take the oil imports out, we find that exports are still rising by about 15 percent and that's a very good show. World trade is only rising by 3 or 4 or 5 percent. So America is now regaining its shares in the world's exports markets and also nonoil imports still look as though they are flattening out.

Now as the earlier discussion suggested, that isn't all good news because there is a basic adverse shift going on in the balance of supply and demand in the United States and that has got to be put right as well.

The second point I want to make about the trade deficit is that a slowdown in the U.S. economy or a recession, which I think is very likely, will do a world of good for the trade deficit.

Now the first reason for that is that U.S. imports are nearly twice as large as U.S. exports and the only thing about a recession is it works on your imports.

But the second is that a lower dollar will have a much more beneficial effect on the U.S. trade balance if demand eases in the United States. I can give you one example of this, Mr. Chairman. I was talking 2 days ago to the chief economist of Weyerhauser. He told me that at the present level of the dollar, Weyerhauser could sell liner board into Sweden, which of course is their major competitor, and make a handsome profit but they're not doing so. Why? Because they can't meet their domestic order.

I also have information to the effect that Du Pont cannot meet its export orders because of strong domestic demand.

Now once those demand pressures here begin to decrease, we shall see a very dramatic decline in the U.S. trade deficit. Here is one of the points on which I would agree with Mr. Ortner, but I don't know that he will be very pleased to hear it. Unfortunately, he's left. He was quite right in saying that it was foreigners' willingness to lend massive amounts of money to the United States which made possible the U.S. trade deficit. Now we can turn that around and say that it is foreigners' unwillingness to lend any more money to the United States which is going to get rid of the U.S. trade deficit. It is going to get rid of it by pushing the dollar down, but that's a very slow process. So now it's going to get rid of it by pushing up U.S. interest rates and pushing down Wall Street and creating a recession in the United States.

Now in that sense, in a rather perverse sense, I am somewhat more optimistic than either Mr. Ortner or Mr. Solomon. I have a bet with my colleagues at the Institute for International Economics that in the first 3 years of the next decade—that's 1990, 1991, and 1992—the United States will, on average, be running a trade and current account surplus. And I'm quite confident about that prediction because if you look at the way market forces are now at work in the world, in fact the world's financial markets are going to force the United States to stop going into debt and in fact publicly to stop repaying debt.

To sum up, Mr. Chairman, it seems to me that two pieces of very bad advice can be at the moment heard from many quarters in this country. The first is that we shouldn't do more than a small cut in the budget deficit because otherwise that would tip the economy into recession; and the second is the Fed should simply print money in order to prevent the recession.

If those two pieces of advice were followed, it might not be a recession; it might be a repeat of the 1930's Great Depression.

On the other hand, if action is taken within the next few weeks, I think we will see only a moderate slowdown, as I said, followed by a strong recovery and then we have a new problem, which is the danger that the dollar might then begin to go up again too soon. But that's another story which I will leave for another time.

Thank you.

[The article attached to Mr. Marris' oral statement follows:]

Op-Ed in the London Times

What happened on Wall Street - and What Happens Next.

by Stephen Marris[*]

There is no mystery about what happened on Wall Street. The mystery is rather why the Dow Jones index rose by over 100 percent in the two years to last August, at a time when the United States was running massive and unsustainable budget deficits and trade deficits.

For the last several years the United States has been living beyond it means - spending more than it has been earning to the tune of 2,000 a year per household. What happened on Wall Street is part of the mechanism whereby - in the absence of drastic action to reduce the budget deficit - the "magic of the market" is going to force American private spending back down into line with income. And unfortunately this process is likely to lead to a recession in the United States that will spread out through the world economy.

Of course, for so long as foreigners were prepared to lend vast sums to the United States there was no problem. But it was foolish to think this could go on indefinitely. Once the dollar began to go down foreigners were exposed to massive exchange-rate losses. Thus the net flow of private capital into the United States, which had been running at over $100 billion in 1986, fell to zero in the early months of this year. This set in motion the first corrective mechanism, a rise in US interest rates, and a drop of over 25 percent in the bond market. This happened despite massive intervention by the world's central banks to support the dollar. Indeed, during this period they were simply printing money to finance the whole of the US trade deficit and, directly or indirectly, more than 80 percent of the budget deficit.

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At first the world's financial markets failed to grasp the full implications of the fact that we have moved, de facto, back into a world of fixed (but hopefully adjustable) exchange rates. Once confidence in the dollar recovered in mid-May, high US interest rates began to look attractive again, and started pulling up Japanese and German rates. At the same time the Bundesbank and the Bank of Japan started trying to mop up the money they had printed to defend the dollar, thus validating the rise in interest rates in the eyes of the markets. Thus by mid-summer the gap between US interest rates had narrowed quite sharply, and it only took some bad monthly trade figures to set off a new run on the dollar.

By early October three things were becoming apparent. First the whole level of world interest rates was being ratcheted up. Second, the central banks were trying to defend the dollar at a level that was unsustainable over the longer run. Third, massive intervention to support the dollar at that level could not continue indefinitely because of its potential inflationary consequences.

While the world's bond markets have been in a slump since the beginning of the year, however, the bull market in equities continued, especially on Wall Street, in Tokyo and in London. Clearly both markets could not be right, because the gap between the yield on bonds and equities rose quite out of line with historical norms. What happened last week was that the world's equity markets realized that they were wrong and the bond markets were right. The result was a massive portfolio shift.

This explains one of the oddities of events over the past few days. The trigger for the slide was clearly the bad U.S. August trade figures and Mr. Baker's hint that the dollar should go down. But the dollar has been surprisingly stable. This suggests that once the slide gathered momentum the main driving force was a shift out of equities in all markets, rather than a shift out of the American market.

What happens next? Quite possibly equity prices will stabilize for a while at a lower and more realistic level, and to that extent the world will be a safer place. But supposing that the equity markets calm down, the basic problem will soon re-emerge. Who is going to be prepared to lend the United States the $10-15 billion a month which is going to be needed to finance its trade deficit? So once the shock waves settle, the markets are going to start worrying again about next month's trade figures, and we are likely to see renewed downward pressure on the dollar and upward pressure on US interest rates.

True, the drop on Wall Street will act as a second corrective mechanism cutting back private spending. Americans have suffered a one trillion dollar capital loss since August, and it would be surprising if they do not start saving more and spending less. The cost of equity capital has risen, and the recent pick-up in investment demand may fade. Painfully, investment will start coming down in line with the inadequate level of domestic savings.

There is of course a much better way of doing this - by cutting the budget deficit. If the United States is to stop borrowing from abroad for a while, as it should, the budget deficit needs to be cut by at least $100 billion over the next two years. Unfortunately, as Britain learned to its cost: There is a great deal of difference between the confidence-building impact of action to cut an excessive budget deficit before the markets lose confidence, and the impact of the same measures after the markets have begun to 'speak'. (Deficits and the Dollar, p. 147).

So on Black Monday the starting gate went up in a race between economic reality and political immobility. More or less everybody in Washington knows what has to be done, except the President. How long it takes to get him to face up to reality will largely determine the future course of events: whether we see only a relatively moderate slowdown in the US economy next year, followed by a strong recovery, or rather a further loss of confidence in the world's financial markets, and a sharp recession spreading out through the world economy. In the end economic reality will prevail, but time is now extremely short.

Representative **McMillan** [presiding]. Thank you, Mr. Marris. The chairman had to also go and vote and he will be back in a few minutes. The House has adjourned for the day, so I think the country is safe until 10 o'clock in the morning. [Laughter.]

I want to focus a little bit further. I know you both addressed this question on the magnitude of the deficit reduction package that is called for.

I have been one among a number of Members on both sides of the aisle in the House who has been seeking to achieve a deficit reduction package with a minimum of $40 billion in the first year with hard reductions in spending in a ratio of 2 to 1 to revenue measures.

We were unable to get the option to even offer a substitute in yesterday's debate, which frankly had within it two alternatives, neither of which I thought was satisfactory, both of which contained in the reconciliation package revenue measures on the one hand of $12 billion and, on the other hand, perhaps $16 billion, and neither of which address forcefully enough the spending side of the ledger.

In fact, in terms of its total impact on the deficit, it wouldn't have had even as much impact as automatic sequestering under Gramm-Rudman.

I am hopeful that as the negotiations proceed next week with the White House and with the Senate that our expectations in terms of what we can achieve this year will rise. I think, Mr. Marris, you expressed yourself forcefully on that subject in that you thought that the arithmetic need was $150 billion, that that should be achieved over 3 years, but you did not address the question as to what proportion you felt should come from the spending side and what proportion from the revenue side.

Would you care to comment on that?

Mr. **Marris**. Well, my college answer to that question is that I'm not myself an American and this is very much a question for Americans to decide for themselves.

Having said that, let me try and answer you. Let me try and give you a package which I think would add up to roughly what's needed.

I think that sort of conceptually there should be two elements in this, one on the spending side. I think, again, conceptually, the most obvious measure would be the deindexation of entitlements so if they rose by 3 percent less than prices for the next 3 or 4 years that would help address the longer run problem of U.S. public finance.

However, that would not be enough. You're going to have to have quite a lot of revenue because there's one other lesson you can learn from other countries—and it's not a very pleasant lesson—if you have to cut the budget deficit quickly, you more or less have to do it by raising taxes. You can't cut a budget deficit very quickly by cutting expenditure. As you know, with defense expenditure, there's a long lag between the appropriations and the actual spending, and on the rest you simply cannot cut people's pensions by 20 percent the next day or something like that, or lay off half the Federal employees.

So again, the experience of other countries suggests that when it comes to the point where you have lost the confidence of the financial markets you have to do something quickly and you have to raise taxes.

Now, in my view, there is one obvious tax that should be raised because this would be killing two birds with one stone, and that's the tax on gasoline, the tax on gasoline at the pump. One cent gives you about a billion dollars. In my program, I would raise the gas tax by 25 cents immediately and I would legislate a further rise of 25 percent on the 1st of January 1989, and another one on the 1st of January 1990.

Now if you add those two measures together and you throw in what probably is the real and present package—and I'm not quite clear how much that is—you get to very nearly my figure and you get to it in a way which I think the markets would regard as not only being convincing in terms of the numbers but addressed to the real problem—addressed to the fact that there is a problem of spending which has to be tackled over the longer run, but also addressed to the problem that there just isn't nobody around to lend the money to the United States to finance this budget deficit anymore, so they will have to raise taxes.

Representative McMILLAN. Did I understand you to say 25 cents per gallon in the first year?

Mr. MARRIS. Yes. That would bring the price of gasoline back roughly to where it was a year or two ago.

Representative McMILLAN. And that would generate approximately $25 billion in revenue?

Mr. MARRIS. A bit more, yes.

Representative McMILLAN. And then you said in successive years 25 cents, so that incrementally over 3 years you would add 75 cents?

Mr. MARRIS. I think I'm right that you get 80 or 90 out of that because I think it's a bit more than a cent a gallon now.

Representative McMILLAN. Following that along just a bit, what impact do you think that would have on the fact that we have, as I understand it, a trade deficit in oil alone of somewhere between $60 and $70 billion a year, which is almost 50 percent of the trade deficit?

Mr. MARRIS. Well, that's why I said it would kill two birds with one stone. It would obviously be a major step toward reversing this deterioration in the supply and demand balance for oil. As you know, part of the problem is that U.S. production of oil is easing off, but the other problem is that consumption of oil per units of GNP is beginning to rise again. We've seen this shift back to larger automobiles. We see an increase in the number of miles driven per automobile, and that is one of the big elements in the total oil demand in the United States.

Representative McMILLAN. Mr. Solomon, would you care to address the same question in terms of the magnitude of the deficit reduction that in your view is needed? I think you mentioned figures that ranged from $23 to $30 billion in the first year and I'm not sure I understood your following statement. I think you said that it needed to be reduced at least to a structural level of $100 billion, or did I misunderstand that?

Mr. SOLOMON. No, that was the trade deficit.

Representative MCMILLAN. That was the trade deficit.

Mr. SOLOMON. I said that in subsequent years it would have to be a multiyear package and that the initial $25 to $30 billion that I thought would be minimally acceptable in the financial markets would have to—that multiyear package legislation now would have to yield an additional $15 to $20 billion deficit reduction in each of the succeeding few years.

I was talking in terms of what is the minimum size that will, in my view, bring about a reasonably favorable reaction in the markets. I was not talking about what is ideal from an economic point of view because I've served in political office also in various administrations so I tend possibly to think more in those terms than maybe Mr. Marris.

If you abstract from political considerations and real life, I would agree with most of what he said. In the real world at the moment I assume that if we can get a multiyear package along the lines I indicated, that would have the satisfatory effect that we're all looking for.

I'm afraid that if you do the kind of package that President Reagan was hinting at in his press conference, you will have a very negative effect in the markets. If you do just one-shot asset sales and other things which are not going to be automatically reducing the deficit in subsequent years, the markets may react quite negatively.

What has happened is that it's not just the United States but in all the key foreign countries there is—since the stock market crash in those countries, there is an enormous anger with the United States, a feeling that it's U.S. policy and a failure in U.S. political leadership which is driving down their markets, and there is a looking toward what—it's almost a dangerous kind of focusing on these negotiations that are going on now. I mean, it's ridiculous for us to have gotten into that situation, but it's like if you follow "Banana Republic" economic policy, then you end up with this kind of an incredible focusing until we get back to something reasonably prudent and normal.

I shouldn't lecture too long, but what has happened in this country in the last few years is that there's been one simplistic economic nostrum after another that's been pushed. You Congressmen are bombarded with views on different economic theories and policies which are incredibly simplistic. At the same time, you know that these economies are very complex and the markets are complex, and the factors affecting them are complex. And there is no way that you can adopt any one simplistic economic policy nostrum.

You have to follow—if you're being responsible statesmen, you have to follow prudent policy. And it's very deceptive and very damaging to the country and to the rest of the world as well to take the politically easy way out. People will then start championing some particular economic policy, and that's true whether it's supply-side economics or other kinds of views.

So I recognize that the political people have quite a problem on their hands. I think you have all exaggerated. You've gotten yourselves into a terrible bind of how much of it is going to be a spending but and how much is going to be a revenue increase. That is completely relatively unimportant today. You have a responsibility to get that budget deficit down and stop arguing with yourselves about whether it's going to be this percentage of reduction in spending—you're just carrying on the ideological argument to such ridiculous degree, when the markets are in such terrible shape and we are really threatened with a global recession.

Representative McMILLAN. When you say "you Congressmen," I think you've got a lot of different types. I happen to be one that's been trying to reach a compromise on that and to get some action because I agree with you, the important thing is to get the deficit down. And I think what we are engaged in is a process of trying to get to that point and the purpose of the Joint Economic Committee is to get testimony of expert witnesses so that hopefully the Congress will react to what is expert testimony rather than the more surface or shallow "Banana Republic" pressures, as you referred to them, that we are faced with.

We are down to a point I think, if we could resolve the question of how much is going into spending cuts and how much is going to be revenue, then I think we would have the deficit package probably put together, and it's getting past that political issue that is the difficult thing that Congress has to reckon with.

I hope we will reckon with it within the next week and on a magnitude of $40 billion. Getting back to my question which had to do with the magnitude that you think is important in terms of sending that signal to the financial markets, a $23 billion package, whether it's all spending cuts or all revenue, against the baseline projection for next year of a deficit of $183 billion would end up with a deficit for 1988 of $160 billion; or $10 to $12 billion above the outlook figure for 1987.

Given that fact, don't you think that at least we should be achieving savings in the $35 to $40 billion range, regardless of whether—let's set aside revenue or expenditure for the moment—you think it should at least have that target as an objective?

Mr. SOLOMON. I agree it would be preferable and I also agree with Mr. Marris' earlier statements that the market confidence building effect is more important to the economy than the reduction of demand and the argument that this will put us into recession.

In fact, if you don't take an impressive enough action in terms of the markets, you are going to have a resumption of the rising interest rates and you will have a recession. It's quite clear.

Now you don't have to necessarily have a recession. You can simply have a weakening or slowing down of the very strong rate that we've had in the last few months, if you have an impressive deficit reduction package.

What I was giving you was a reaction to what I see in the press and what I hear from my friends in Washington that it's extremely unlikely that the negotiations between the administration and Congress will produce more than an alternative to the automatic across-the-board Gramm-Rudman cuts.

What I was saying is that the important thing is that it must be multiyear and cannot consist of one-shot asset sales. If it does, there will be a negative reaction in the markets.

So I don't really put as much importance I guess on the difference between $25 to $30 billion as against $35 to $40 billion as I do on the composition of this in terms of impressing the market. Again, I don't want to repeat myself, but I really feel that this business of arguing how much of it will be spending cuts and how much will be tax increases—you've been doing that for 5 years and I think it's ridiculous now. The situation has gotten to a point where that is very unimportant. I don't think it even makes that much difference at the polls any longer, whether you have the ideological image of a spending cut guy or the ideological image of a revenue increasing guy because people are beginning to recognize that there's an urgency to the situation and it requires a compromise among prudent and sensible people in politics, on both sides.

Representative McMillan. I agree with you: we need to get on with making the decision. But Congressmen and Senators don't have the luxury of saying those two factors are irrelevant because they've got to decide which one they are going to emphasize.

Let me comment on the issue of asset sales. I think you are absolutely right. This deficit reduction should not include any proceeds from asset sales as a means of reducing the current deficit. In fact, it should be treated for retiring indebtedness and if there are any benefits on the current deficit, then it's a reduction of the interest cost because you have less debt than you otherwise would have had.

I have one final question, and I guess I should address this to Mr. Marris.

With the issue that you raised about foreign capital flows reverting to the central banks, in a sense, isn't their real interest in doing this to protect the trade surpluses they enjoy with the United States? And if in fact they, for whatever reasons, decide they can no longer do that, isn't that then going to automatically reduce that trade surplus they enjoy with this country?

Mr. Marris. Sure. Everybody is trying to put off the evil day and they are trying to put it off, too, by financing the United States rather than adjusting to it.

And that is what has made it so difficult for the United States in the conduct of its policy because clearly Mr. Baker was absolutely right to feel that the other countries have not been playing their part and he was also right to think that the one thing that seems to clarify their minds remarkably is when their currencies start going up and their industrialists start getting worried about their exports. The only thing is that there's always a balance of terror between the two sides of an exchange rate, when it's in danger of getting out of control. In January, the Germans were just about as frightened about the mark going up as Mr. Baker became at that point about the dollar going down, so they came to a fairly sensible conclusion.

Unfortunately, when he tried again 2 weeks ago, the Germans were feeling fairly happy. They were in a rather complacent mood.

I would like to just come back to something that Tony Solomon said. I think perhaps the most important thing that you've got to realize on the Hill now when you're looking at your budget package is that it's not now just a question of how will it play in Peoria, but how will it play in Frankfurt, in London, and in Tokyo.

I was in London last Friday and I must tell you that the rest of the world is, as Tony Solomon said, angry, and that what they are saying is, "Well, now the United States really has got to do something," and they are expecting you to do something. And so do I actually. The only thing is I think you're going to get your first package wrong and then the markets are going to speak again.

The truth is that U.S. interest rates are going to have to raise as far and Wall Street is going to have to fall as far as is necessary to get the administration and Congress to take decisive action on the budget deficit. If it doesn't do it this time, then it won't be an 1800 Dow, it will be a 1300 Dow, and the package will have to be that much bigger.

There's another problem here. I agree with Tony Solomon that the right answer is a multiyear package. Indeed, I suggested it myself. But the trouble is that over the last 2 or 3 years the administration and Congress have really debased the idea of multiyear packages. We've had about four multiyear packages. The last one, which was the revised Gramm-Rudman, was perfectly clear a multiyear package which was designed to ensure you didn't have to do anything in the first year. Everything was put into the future.

Mr. SOLOMON. That was a multiyear package of objectives.

Mr. MARRIS. And the objective, if I remember rightly, for next year is $144 billion and the actual deficit is $148 billion.

Mr. SOLOMON. I'm not talking about objectives.

Mr. MARRIS. In other words, the objective was not adequate for the first year and it was pushed out and we were told, oh, that's all right, by 1990 or 1991 it will have come down.

Now given that, I think it's now a case where the first year package will have to be bigger than Tony Solomon has suggested, although the more it can be backed up by a credible second and third year package, the smaller it can be. But that's why I was suggesting that you need something more of the order of $50 to $60 billion now for this coming year. That, as you say, from a base of somewhere around $180 billion. So that's only bringing the budget deficit down to $120 billion, but that is at least $30 billion lower than it was in fiscal 1986.

Mr. SOLOMON. I should clarify, if there's any confusion, what I meant by multiyear was that the components of the package of the revenue increases and the spending cuts should be automatically repeatable. I'm not talking about legislating something that comes into effect next year or the year after, let alone objectives.

Senator SARBANES [presiding]. Would you apply that analysis to the current deficit figure which is much lower than anyone anticipated because of some one-time factors?

Mr. SOLOMON. Well, you see, I come from the financial community and we have had in the financial community among leaders in the financial community, the heads of some of the major banks and investment firms—we have had some private meetings, and I would say that there is—it's hard always to say there's a minimum consensus view as to what the minimum action is that would reasonably satisfy the markets. I have said to you what I think is that minimum consensus view, not the ideal action, which I think is what Steve Marris is talking about, but the minimum view is that if there is something in the neighborhood of $25 to $30 billion and a promise that this will increase each year by another $15 or $20 billion because of the nature of the cuts will automatically lead to that, then you've got the direction right and the markets will not focus so much on the difference as to whether it's $140 billion or whether it's $160 billion or whether it's $190 billion. Actually, you may get some weakening of the economy and you may not even come in at $170 billion, which I guess is a more recent projection. The markets will not look primarily at that. They will look and see whether there is a high probability that there will be very substantial improvement than what it otherwise would be each year for the next few years. And I put that in that magnitude range.

I don't think that we should aim at a specific number. I mean, sure, you automatically are doing that under present budget assumptions and present economic assumptions, but these can change—the economic assumptions may change drastically over the next few months. So I don't think you can foresee that. You don't know and we don't know how weak the economy is going to get. Therefore, for you to say that we want to hit that absolute number of a budget deficit I think is kidding yourselves and ourselves.

What you really want to do is convince the world and the markets at home and abroad and that you are going to reduce that budgetary deficit by a very significant amount this year and the following year and the following year.

Senator **Sarbanes**. Well, that was one of the problems in my view with Gramm-Rudman. It was using fixed numbers that were relatively unrelated to the condition of the economy. I think the more appropriate response would be to change the spending and revenue trend lines in such a way as to narrow the gap from year to year to year and assure that the factors used to narrow the gap were lasting and permanent and not a one-fix proposition. That is the important perception.

Now this year's deficit, which Secretary Baker announced, shows a sharp drop. When you look at its components, however, you find that a lot of things in there are one-time propositions.

Mr. **Solomon**. I agree completely, Senator.

Senator **Sarbanes**. And then people say, well, you've got to use that as your base figure to judge the next year, and then they say $25 to $30 billion isn't enough. Well, that may be, if you're working off that base figure—you are in effect making permanent in some way or other an amount that was equal to the one-time fix that took place in the current fiscal year.

Mr. **Marris**. Could I just add a point on that? I very much agree with what Tony Solomon said. When I said that there may be occasions when you have to turn Lord Keynes on his head, there are two possible definitions of that. One is to enact cuts in the budget deficit even though the economy is weak. That is what I'm saying may have to be done. The other is that if the economy weakens the budget deficit is going to get bigger and then you try and cut that budget deficit.

Senator **Sarbanes**. Now how do you square those two, one with the other?

Mr. **Marris**. Well, that's the much more extreme form. What I will have to tell you is that that most extreme form which is the

Government seeing the budget deficit rising because of a recession has had then to take action to try and cut the budget deficit has actually happened. It happened in Belgium. It happened in Denmark. It happened in the Netherlands. I don't think the United States is anything nearly in such a bad position now anyway as they were, and I agree that the cuts should be from what we call the structural budget deficit or the full-employment budget deficit, recognizing that in fact the budget deficit next year is probably going to come out higher because the economy is going to be weak.

Senator **Sarbanes**. Do you think the United States can look to Belgium and Denmark for instruction on the economy, given the differing roles of our economies in the world economy?

Mr. **Marris**. There are some things which are rather similar, like the very large budget deficits, but theirs were larger.

Senator **Sarbanes**. Well, your position, I take it, is that a very large budget deficit cut does not run the risk of pushing us into a recession.

Mr. **Marris**. You need to get it just right. It must be large enough to restore confidence and no larger than it has to be. But that's a very, very difficult judgment.

Senator **Sarbanes**. I want to be very clear on this. There was a story in the Times on the 28th by Leonard Silk, "Perilous Economic Cures. Some experts see tax increases and cuts in spending by U.S. as spurs to recession."

Now do you discount that totally?

Mr. **Marris**. Very largely, yes.

Senator **Sarbanes**. You do. So you would say you could cut $100 billion or $150 billion?

Mr. **Marris**. Over 3 years.

Senator **Sarbanes**. How about in a year?

Mr. **Marris**. No.

Senator **Sarbanes**. Why not?

Mr. **Marris**. That would be far more than the markets would need to restore confidence and indeed it would destroy confidence because that much purchasing power taken out of the economy in 1 year would certainly lead to a recession and a nasty one.

Senator **Sarbanes**. So you don't discount this argument totally.

Mr. **Marris**. No. It's a question of finding exactly the right magnitude to pull off this confidence trick. That's what we're talking about. We're talking about market psychology.

Senator **Sarbanes**. Would you do more than is necessary to do the confidence trick or would you not do that because you would be worried that that might in fact push it downwards?

Mr. **Marris**. Senator, I suppose my answer to that is I could probably put together 20 cases of governments facing a situation like it and in 15 they got the figure too low and in 5 they got it right.

I don't know of a country which overdid it because the political situation—I mean, Tony Solomon has been talking about this and the political reality—the political reality is that the likelihood of you actually doing overkill is not very great.

Senator **Sarbanes**. The two of you have come in here this morning with recommendations that are quite far apart. One of you tells us that if we do what I say it will probably handle the confidence problem, and the other says, well, if you do what I say this is what's needed to resolve the confidence problem, and it's on the order of magnitude of double.

Mr. **Solomon**. But in the first year, I think we both agree completely that the composition of the deficit reducing package has to come automatically into play each year and you will see that I say that the second year should go up by—reduce the deficit by an additional $15 to $20 billion in order to get the right market reaction.

Senator **Sarbanes**. Well, that's right.

Mr. **Solomon**. So therefore, by the second year——

Senator **Sarbanes**. You are less than half of Mr. Marris' figures. That's a big difference when you're trying to make those judgments up here.

I agree completely with the proposition that you can't have gimmicks because you're only buying trouble when you do that and it doesn't help to restore confidence. If anything, it worsens the situation. And I also agree with the notion that it has to be done in a way that changes the trend lines on a year-to-year basis on a continuing basis.

Then the question is, How much are you talking about in order to do that? And then how great is the risk that if in fact you do too much you will help to precipitate a downturn? If you get a downturn, the deficit is going to go up automatically.

Mr. **Solomon**. But, Senator, I don't think there's as much difference between us as you're reading, for this reason. I said that I was saying what was the minimum package that would have the right psychological impact on the markets. If I had my druthers and if I were speaking as a pure economist, I would probably recommend something closer, as I said earlier, to what Steve Marris is recommending.

Senator **Sarbanes**. Why would you do that? If your other figure is enough to restore confidence—let's accept that premise—and if you recognize apparently—I didn't ask you the question I asked Steve Marris, but I'll ask it now—do you discount the view that you could seek to reduce it by so much so quickly that you would precipitate a downturn?

Mr. **Solomon**. No, I don't discount that.

Senator **Sarbanes**. You don't discount that.

Mr. **Solomon**. Let me explain one thing. There's a difference between us which hasn't come out in the testimony, which is this. I would not aim for budget balance over 3 years. I would aim for whatever the level was that would be a deficit financable from domestic savings, along with private sector capital needs.

Now I will admit that if our saving rate stays as low as it has dropped the last year or two, then it probably would be we would have to move to balance. But if you look at the pre-Reagan period, the normal period—the normal pattern was that you could finance a deficit equivalent to 1½ percent or 2 percent of GNP without relying on imported capital. Therefore, I don't know what the saving rate is going to be 2 or 3 years from now. It may very well improve though and go back to a more normal level of something in the neighborhood of 6 percent. As the economy weakens there are many other factors that would change that.

If it does go back to what I call the pre-Reagan normal, then we could easily tolerate a budget deficit of 1½ or 2 percent GNP.

Now that's a personal view and under today's savings rate I would agree that we should move to balance over a 3-year period. Steve Marris may or may not agree with me on the way I formulate what I think is the objective.

Because I have this kind of basic assumption in the back of my mind, therefore I am not putting out numbers that we necessarily have to cut as much as $150 billion over a 3-year period. I don't know what it would be.

I think, though, that I'm a little worried about overkill. I'm a little worried that you could damage market confidence if you came up—it's very unlikely that you will—but if you came up with too large a package. I think if you were to announce that you've legislated actions which will automatically reduce the budget deficit on present economic assumptions $50 billion mounting each year over a 3-year period, I'm a little worried that there might be some shock to the market from businessmen and other people cutting back on their capital programs.

I guess I would feel a little more comfortable with something less than that and a little less rigid than that. So I say somewhere in this $25 to $30 billion minimum, moving up substantially maybe by the same amount each of the next 2 years. If you could legislate a package like that, I think that you would probably have the best psychological impact.

I don't know if there's that much difference between us in reality because I think that Steve Marris also would feel that there are some problems here. I don't know.

Mr. MARRIS. In my book I tried to analyze what would be the full employment excess savings in the private sector available to finance the budget deficit. I came to about a half a percent, somewhere between a half a percent and 1 percent of GNP, rather than your figure.

Mr. SOLOMON. At present savings rates?

Mr. MARRIS. No, not at present savings rates. That was going back over the last 20 years and looking at what was the situation under full employment.

Representative MCMILLAN. So for the viewing audience, then you're talking $40 or $50 billion?

Mr. MARRIS. Something like that. Now I have an additional factor in that which I suppose comes from my international background. I think it would be very, very good for the United States and actually for the rest of the world for the United States to run a small current account surplus in the next decade to pay back some of this debt. You're going to have $500 or $600 billion of debt whatever happens. I think it would be very good for the dollar, which is obviously the world's currency, for America to repay not a whole lot but some of its debt. If you're going to do that, then you will need to use some of your domestic savings to finance a surplus on the current account.

I suspect that the real difference between Tony Solomon and I—we know each other quite well—is that Tony is actually thinking in terms of what people are currently thinking is possible or desirable or minimum necessary in New York, whereas I am profoundly concerned about what people are going to consider is adequate and decisive in London, in Frankfurt, and in Tokyo. And I think that may possibly be why we have different orders of magnitude.

I do have the impression that neither the American public nor the American Congress nor the American financial markets yet have grasped the sheer magnitude of the problem. I think probably the rest of the world has.

Representative McMillan. One comment. Chairman Volcker, in testifying on the Hill earlier this year, said that he didn't lose any sleep at night worrying about whether or not Congress would reduce spending enough to cause an economic downturn. But it should be said that if you look back over figures, the rate of increase in spending in the Federal budget from about 1978 through 1985 increased at an annual double digit rate—10 or 11 percent—whereas from 1985 to 1986 it dropped to 4-percent plus and last year I think outlays were 1.2 percent above the prior year. And we've been able to do that without causing any major economic consequences it seems.

So on the magnitude that we're talking about of reducing spending, it would seem safe to say that we are not likely to precipitate any major economic downturn if we're talking in terms of reducing the level of projected spending by $20 or $30 billion next year.

Mr. Solomon. Yes. I think your comparison is probably not too valid, but I agree with the bottom line.

The reason why it's not too valid is that I expect the economy to weaken as a result of these shocks that we have had. Consumer spending will be down, and so forth. So that's why some people are more concerned about whether you tip the economy into recession or not. Now it's a tradeoff. There is some legitimacy to that concern.

On the other hand, the market creating confidence, the foreign creating confidence, of showing satisfactory progress in reducing the deficit, in my opinion, far outweighs the reduction of a relatively modest amount of purchasing power in the economy.

I think that the bottom line I agree with completely, but I don't think you can look back at the experience of the last year and say, well that didn't put us in a recession so why should this because last year's conditions will be different than the next year's conditions.

Senator Sarbanes. I just want to make this observation out of our annual report. I don't know whether you can see that chart from there, but these are Federal Government purchases, these two lines [indicating]. The upper one that rises very steeply beginning in 1980 is defense. The lower one, which really shows a fairly restrained growth pattern, is domestic spending.

I think it's very important to interject that at this point because the focus has constantly been on discussing spending on these domestic programs where there's obviously been a significant amount of restraint, and the really sharp rise in Federal Government spending has been in the military component, coupled with the reduction in the revenue base that's taken place.

Those are the two factors that have opened up the deficit over these last few years—the increase in defense spending and some erosion of the revenue base. Domestic spending has been—that's not to say that more can't be done—as this chart indicates, sharply restrained.

I want to ask this question because you made reference to how London and Frankfurt and Tokyo are going to react. Do you think that the other strong economies are assuming their fair share of economic responsibility for the world economy?

Mr. **Marris**. No. I think we would both quite clearly answer no to that. I concentrated in my testimony on the U.S. situation because since the Wall Street slide this is now the crucial place. However, I think that the other countries in their way have been just as obdurate and just as blind and are also going to, under the pressure of the world's financial markets, have to change their policies.

Essentially, Europe and Japan have been riding on the back of the American expansion through the 1980's. That stopped somewhere around the middle of last year and we saw immediately in fact a slowdown both in Europe and in Japan. The Japanese I'm glad to say, although they were a bit slow at the first, have begun to react the right way and one of the brightest spots in the world economy at the moment is the strength of domestic demand in Japan. However, I think we have to be worried as to how much that may have been due to the incredible levels of the Tokyo Stock Exchange rose to and I think it's very likely that there will have to be more expansionary action in Japan.

But it's when I look to Europe that I'm really very, very worried. Growth is very low in Europe. Unemployment is very high. And even that is only—this low growth is only coming about because Europe is at the moment—the European economy is being pulled along by four locomotives. These are Spain, Portugal, Italy and my own country Britain, and those countries are not going to be able to pull Europe along very long.

My own country is still a convalescent. It cannot be growing twice as fast as Germany, which is what it's doing at the moment, and therefore, there is likely to be a very significant slowdown in European growth if, as we all think, there is also a slowdown in the United States and a dramatic improvement in the U.S. trade balance, and it all comes around to Germany, where when I sort of talk to my German friends one finds almost exactly the same kind of political paralysis that one sees here in Washington. Almost all the people I talk to agree that what is needed is a fiscal stimulus, but they all disagree about which way it should be done. It's exactly the reverse problem to here. Some of them want to cut income tax. Some of them want to increase public expenditure. Some of them want to do a bit of both. They want to cut subsidies and taxes at the same time, but they simply can't put their act together.

Now this is very worrying. However, I think there's one point that is a fact in the situation, whether we like it or not. My German friends do have a rather moralistic view of economics and they have some reason for doing so. They feel they have been virtuous and they feel that they have set an example. And precisely because of what I think is however an unduly moralistic and insufficiently pragmatic attitude, they feel terribly strongly about what they believe is the main cause of the world's problems, which is the U.S. budget deficit. And it certainly will make for a major change in the debate among countries about what should be done once you have done something. Then it's going to be possible to turn around to the Germans and say, okay, now it's your turn. But until we've really got something on this side of the Atlantic, we've got at the moment a very obstinate and, as Tony Solomon said, an angry mood in Europe.

Mr. **Solomon**. And I said the same thing in my statement, that there is a better chance that we can get Germany to cooperate if we showed that we were taking this long delayed action on the budget deficit. But even if they don't cooperate, if they still prove to be very moralistic and superior and virtuous and bourgeois in their culture, then, okay, we still have to do it for our own reasons. It's just that if they would also take the action, it would be that much more helpful in terms of our adjustment in the global economy.

Senator **Sarbanes**. Let me ask you this question, since we're trying to take a longer term view. You have both indicated that in terms of the relative strengths of their national economies that other countries are not assuming a commensurate responsibility.

Why, if you're really rethinking it, wouldn't it be reasonable for the United States to factor in the relative security burdens which countries are assuming? In other words, we're carrying 6.5 percent of our GNP in defense. Now maybe that's too much. We argue amongst ourselves whether that's too much. But in any event, even if it were somewhat less, it would still be significantly more than these other advanced industrial economies that are accumulating these large current account surpluses they're carrying.

They tend to separate these segments so that you talk security, in one category and economics in another. It seems to me that they are obviously interrelated.

Japan spends 1 percent of its GNP on defense. One approach to that is to try to force them to rearm, which has a lot of very serious implications, in my view. Another approach is to say, if you're going to be sheltered under the security umbrella that the United States is essentially providing and don't have the burden of defense spending on your economic strengths, then you have to do certain things in the economic area to contribute toward world economic growth. I mean not only faster growth within Japan but recirculation of those surpluses into the developing world to make them part of an engine of growth for the world economy.

It seems to me that we are not asking the tough questions. The world is continuing to operate in the framework of the immediate post-World War II period, when the United States was so totally dominant.

Mr. **Solomon**. Mr. Chairman, I was Assistant Secretary of State in the Johnson administration. I can assure you I used that argument to some people and I'm sure in the current administration they are using privately that argument.

The basic problem is, do we have the political will when they don't respond to that argument, but the argument has been used and the pressure has been attempted on Germany—when they don't respond to that, are we willing to take this from the point of view of simply pressure and diplomatic persuasion to actually implementing certain threats?

That is a very major question and my judgment is I have yet to see an administration in this country which puts its economic interests on a level with its conception, its view, and its self-image of the United States as the defender of the free world and the leader of the free world and let alone don't we use our alliances for economic leverage; on the contrary, it's even worse than that, we are so afraid of endangering our security alliances, our political and security alliances, that we sometimes accept knowingly certain economic disadvantages.

Senator **Sarbanes**. We provide the security and then at the same time we make economic concessions.

Mr. **Solomon**. Yes, but are you really prepared—I'm not giving my own view at this point. I'm just raising the question. Are you really prepared, if you were President of the United States, to say, "Okay. You've said no. I've pressured you and you've said no. Therefore, I'm going to bring back half of my troops from Europe." Are you prepared to do that?

Senator **Sarbanes**. No. You could take economic steps.

Mr. **Solomon**. Like what?

Senator **Sarbanes**. Like access to the American market.

Mr. **Solomon**. But that's a protectionist action which would damage ourselves.

Senator **Sarbanes**. No, no. It doesn't start out to be a protectionist action. It starts out to be in fact an expansionist action. Why should we provide greater access into our markets than is being provided to us in the particular countries' markets?

Mr. **Solomon**. With the exception of agriculture, I'm not aware that Germany—incidentally, not even Japan, where it's with the exception of agriculture—I'm not aware that they have higher import barriers than we do. That may be a perception that's around. I don't think it's an accurate one.

The reason they are surplus countries is not because they have greater trade barriers or import barriers. The reason they are surplus countries is because they run very modest public sector deficits and for the country as a whole they have very large savings. Therefore, the macroeconomics work out inevitably over a period of time that they are going to be surplus countries, run surplus in their balance of trade and their current account balances.

Senator **Sarbanes**. Well, first of all, we've suffered in a devastating way for the overvaluation of the American dollar in the first part of the 1980's. It was almost like committing suicide. I've talked to Europeans who said they never understood why the United States took the position it took during that period of time. We priced ourselves out of those markets.

Now we find that some of these currencies, when we finally address the problems, work according to the markets, and we see movements in the mark and the yen. But there are other countries that are playing their currency against the American dollar to serve their trade purposes—Taiwan, for example.

Mr. **Solomon**. But putting Taiwan aside, which is a special case, we could have moderated the rise in the dollar, which was so damaging to us, if we continued the policy—this sounds terrible and I apologize—but if we continued the policy that I instituted when I was at Treasury and at the Fed, which is when we saw excessive rapid appreciation of the dollar, we sold dollars and acquired a war chest of foreign currencies.

However, that was only a temporary moderation that could have been achieved and the Reagan administration chose not to follow that policy. But even if they had chosen to continue that policy instead of abruptly canceling it the minute they came into office, it still would not in the long run have changed the fact that running this big a budgetary deficit would raise interest rates in this country, would attract foreign capital, and you would thereby get an appreciation of the dollar to the level where we lost our competitiveness. That would have happened anyway even if we had continued to follow a policy of trying to check the rise of the dollar through intervention against the dollar.

So you still come back to the question of they run tighter fiscal and monetary policies than they should in surplus countries and we run an extravagantly imprudent policy, and the rest of the world is looking at us because to some degree it was our deficit that permitted them to run such large surpluses. And if we take action to curb our budgetary deficit, which will have a favorable impact over a period of time on our trade deficit and current account deficit, that will also tend to reduce the surplus currency countries.

I think there is no excuse for us failing to take the action, even though I recognize and have long argued publicly in speeches—in fact, in Germany, they mockingly describe me as the locomotive because I have been pushing them to do more. But it's something that we have to take the action to correct our own situation and it may give us some more leverage. I don't see that you can restrict access to markets without damaging ourselves. There would be no justification for a perception of fairness if we were to take that kind of action.

Senator **Sarbanes**. No. I said we should seek a reduction in foreign trade barriers.

That light means I'm going to have to bring this to a close because there's a vote. Let me just make this point.

It seems to me there's a problem in trying to approach economic problems with a heavy reliance on only one factor, without addressing a number of things that need to be done. We need to address our own budget deficit, and in doing that we need to address a number of factors instead of one factor alone. One of the reasons it's been so difficult to address the budget problem is the President's insistence that only domestic spending be addressed—only—not military spending and not revenues.

Obviously if you can address all of them, you can put together a balanced package. That is precluded if you address only one of the three factors. By the same token, it seems to be that while you're addressing the American budget deficit, there are other things that need to be addressed as well. The unfair trade barriers that we confront that make trade not a two-way street, appropriate exchange rates so we're not disadvantaged simply by the valuation of the currency, better economic policy coordination amongst the industrial countries. So the others are part of being the locomotive as well. A solution to the debt crisis in the developing countries so they can get back on track in terms of making a contribution toward world economic growth. Just because we're the single largest economy doesn't necessarily mean that we should assume the full measure of that responsibility.

If you do all of that, you can end up putting together an economic package that people will see as really offering a prospect for working out of these difficulties.

Mr. **Solomon**. But if you were implying that you have to do those simultaneously in one package, then that's a prescription for doing nothing.

Senator **Sarbanes**. No. You have to move when you can move, obviously, and there are certain parts of that package in which the United States can take the lead because it can do it, in a sense, by itself or at least do a good part of it by itself. There are other parts that others have to join in doing either cooperatively, I would hope, but if not, it seems to me we have to bring some pressure to bear. Otherwise why wouldn't others always work under our umbrella to their advantage? If we don't bring the pressure to bear and you're in the other country, why wouldn't you say, "Well, as long as we can get away with it, why don't we let the United States provide the security umbrella and let them provide the economic leadership and we will work under that? We'll work under that to our advantage." Why wouldn't you do that? You would have to have a very enlightened calculation of self-interest to say, "Eventually the world economy is not going to be able to work this way." Unless you had that perception, why wouldn't you play that game?

Mr. **Solomon**. They might very well unless, as you say, they have an enlightened self-interest view, and I agree that increased pressure has to be brought. If we're doing the right things and they still are not cooperating, then I agree we should bring increased pressure. I would not want to see that in terms of trade barriers. I think that would damage all of us very badly and us even worse.

For example, there are pressures that can be brought in the security areas itself. If it's an intolerable price that we're paying, then you can gradually embark on a program of reducing our overseas security expenditures and that will make people sit up and—you don't have to take a dramatic overnight action, but you can start to embark on a program of reducing overseas security expenditures and say this is going to continue until you accept a fair share of the burden.

Senator **Sarbanes**. Well, thank you all very much. It's been a helpful hearing. The committee stands adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

THE U.S. INTERNATIONAL IMBALANCES

THURSDAY, NOVEMBER 5, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senator Sarbanes; and Representatives Scheuer, Wylie, and McMillan.

Also present: Judith Davison, executive director; and Lee Price, Jim Klumpner, Dan Bond, and John Starrels, professional staff members.

Representative **Scheuer** [presiding]. Good morning.

This is the third in a series of Joint Economic Committee hearings on the U.S. trade deficit. Senator Paul Sarbanes, the chairman of the Joint Economic Committee, has been detained at a meeting of the Select Committee on the Iran-Contra problem and he will be here anon. He has asked me to substitute for him for a few minutes.

At the first of these three hearings the witnesses agreed that an improvement in our trade deficit would require a further decline in the value of the dollar which indeed the market seems to be carrying out even as we speak. The dollar closed in Tokyo yesterday at just over 135 yen, the lowest level since World War II. When I was in Japan in 1978, the dollar was about 220 to the yen.

At the second hearing, Robert Ortner admitted that the nominal current account deficit would not be any lower in 1987 than in 1986, despite earlier administration predictions of a decline in the range of perhaps $20 billion or more.

Stephen Marris and Tony Solomon, former chairman of the New York Fed, testified that Congress has to cut the budget deficit by at least $23 billion this year, which of course they have to do under Gramm-Rudman, with Marris calling for a total cut of $100 billion over the next 2 years. Marris advocated a 25-cent-per-gallon gasoline tax for the first year and 50 cents the next year and 75 cents the third year. Both agreed that any deficit cutting plan should extend beyond fiscal 1988 and be a long-term plan and that such a long-term plan would show our determination to get our fiscal and budgetary act together and would be the element to which the markets, both at home and abroad, would respond. A long-term commitment to do the necessary.

Today's hearing will focus on the trade outlook for specific industries—agriculture, capital goods, and high tech. The opening witness will be Edward Gramlich, Acting Director of the Congressional Budget Office, who will review the effects of changes in exchange rates on economic growth.

Then he will be followed by a panel, including Roger Bird, vice president, International Services, Wharton Econometrics; Martin Abel, an agricultural economist and president of Abel, Daft & Earley; and Stephen Roach, senior economist at Morgan Stanley & Co.

Before we begin, Senator D'Amato has requested that his written opening statement be placed in the hearing record; without objection, so ordered.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES, HERE TO DISCUSS THEIR VIEWS ON THE PROSPECTS FOR EXPORTS AND IMPORTS IN THE COMING MONTHS.

OUR ENORMOUS AND UNPRECEDENTED TRADE DEFICIT IS, IRONICALLY, RELATED TO THE DOLLAR'S ROLE AS THE WORLD'S CHIEF INTERNATIONAL CURRENCY. THE DOLLAR APPRECIATED MORE THAN 60 PERCENT BETWEEN 1980 AND 1985. A STRONG DOLLAR HELPED BOOST THE PRICE OF U.S. EXPORTS, CAUSING FOREIGN CONSUMERS TO TURN TO CHEAPER ALTERNATIVES. U.S. PRODUCTS BEGAN TO LOSE THEIR COMPETITIVE EDGE. OUR TRADE DEFICIT GREW WHILE FOREIGN SURPLUSES MUSHROOMED.

WHILE THE DECLINE OF THE DOLLAR OVER THE PAST TWO YEARS HAS HELPED REDUCE THE TRADE DEFICIT, THE IMPROVEMENT HAS NOT BEEN DRAMATIC.

TRADE BARRIERS AND CLOSED FOREIGN MARKETS HAVE KEPT MANY AMERICAN PRODUCTS FROM COMPETING ON AN EQUAL BASIS WITH FOREIGN PRODUCTS. AMERICAN INDUSTRIES HAVE COMPLAINED ABOUT

THE INABILITY TO COMPETE AGAINST IMPORTS PRODUCED LESS EXPENSIVELY. MANY OF THESE INDUSTRIES HAVE SOUGHT RELIEF FROM THE GOVERNMENT IN REQUESTING HIGHER TARIFFS OR HIGHER QUOTAS BEING PLACED ON IMPORTS.

THE TIDE OF PROTECTIONISM HAS RISEN OVER THE PAST YEAR. THE PENDING TRADE BILL CONTAINS SOME PROTECTIONIST MEASURES THAT MAY BE DETRIMENTAL TO THIS COUNTRY'S ECONOMY - CURES WORSE, IN SOME CASES, THAN THE DISEASE. I AM INTERESTED IN THE TESTIMONY OF TODAY'S WITNESSES AND THE INSIGHT THAT THEY ARE SURE TO PROVIDE TO THIS COMMITTEE ON THE PROSPECTS FOR EXPORTS AND IMPORTS IN THE FUTURE.

THANK YOU, MR. CHAIRMAN.

Representative SCHEUER. We are delighted to have you here, Mr. Gramlich. As you know, your prepared statement will be printed in the record in full, so perhaps you could chat informally with us for 8 or 10 minutes and then I'm sure that Alex McMillan and I will have some questions for you.

STATEMENT OF EDWARD M. GRAMLICH, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY STEPHAN THURMAN

Mr. GRAMLICH. Thank you very much, Mr. Chairman. I have to my left Stephan Thurman, who is the leading expert in this area and performed many of the calculations upon which our testimony is based.

I am pleased to have this opportunity to discuss the conditions under which the current deficit might improve. The Congressional Budget Office (CBO) has been concerned for some time with the continued high current account deficits. In recent weeks, we have seen what a loss of investor confidence can do to world stock markets. If foreign investors lose confidence in the United States because the current account deficit refuses to fall, we could see similar effects on foreign exchange markets leading to possible disruptions in the world economic and trading system.

Today, I would like to report on some experiments we have performed at CBO recently to find out what it will take for the current account deficit to turn around and then continue shrinking. I should emphasize at the outset that none of these experiments represent CBO's forecast of what will happen or when it may happen. The experiments are purely hypothetical investigations designed to answer questions such as what would happen under various conditions.

In our investigations we examined three developments, each of which was expected to have a positive effect on net exports, the major component of the current account balance. We then compared their effects with the baseline deficit in our August updated forecast. The timeframe we chose to examine was the present through 1992, using the same period from the August projection for comparison. The three hypothetical situations are: First, a typical recession in the United States; second, some notion of faster economic growth in the world; and third, a very rapid fall in the value of the dollar. We also combined these three elements in an experiment to see what their joint effect on the current account balance would be.

Before I describe the experiments, let me say a few words here about the baseline used in the simulations. The baseline we used for evaluating all experiments was the net export path, which is broadly consistent with the August updated forecast.

You can follow this discussion by looking at table 1 of the prepared statement. You can see in the top row of the table that the nominal net exports deficit begins at roughly $110 billion in 1987. That nominal deficit rises to $177 by 1992 in the baseline forecast. The real net export deficit begins at $123 billion and falls to $84 billion over the same period in the baseline forecast.

The paths are different for nominal and real values because during this period of the baseline forecast the dollar is depreciating; this raises the nominal but not the real value of imports. That is why the two tend to diverge. The nominal net export deficit is an indication of how much our international debt is growing and related matters. Actually, the current account balance is the main indicator for such matters and the nominal net export deficit is one component of that. The real net export deficit, on the other hand, is an indication of how much the trade balance is contributing to GNP. Both are important in some sense.

Turning to our experiments, the first hypothetical situation is a recession, and here we examined the effect of a typical postwar recession starting in the first quarter of 1988. During this hypothetical recession, GNP falls for two quarters and grows only weakly in the third quarter of 1988 and then returns to its baseline level after about 5 years.

The effect of the recession, which is presented in tables 1 and 2 of the prepared statement, is to produce a sharp improvement in both the nominal and real net export balances in 1988. The real net export balance then continues to improve, except for a small reversal in 1990, but the nominal balance starts to deteriorate once again in 1989 and continues to worsen through 1992. By 1992, the effect of the recession is to decrease the nominal deficit by only $9 billion when compared to the baseline, which is essentially no change, and the real deficit by a similar small amount.

The first experiment shows, therefore, that a recession, unless it were of extremely severe proportions, would really have only a slight permanent effect on the current account deficit.

The second experiment relates to foreign growth, and here we investigated the effect of faster economic growth in the rest of the world. We also adjusted one of the forecast model variables, which determines how much countries buy at given income levels. The adjustment made was quite large in order to investigate the outside bounds of what might be plausible.

With a higher foreign income elasticity and a faster foreign growth, U.S. nominal net exports first improve slightly in 1988 but then continue to deteriorate but at a slower rate than in the baseline. Real net exports improve significantly in 1988 but then more slowly in subsequent years. By 1992, the nominal and real deficits fall by $44 billion and $35 billion respectively, below baseline values. This change, then, is bigger than in the recession scenario but it is still small compared to the initial magnitude of the deficit.

The third experiment involved a rapid depreciation of the dollar. In the baseline forecast, the dollar was depreciating steadily throughout the whole period through 1992. "Front-loaded depreciation" in table 2 of the prepared statement, means that in this experiment the dollar accomplishes all of that depreciation at the beginning of the projection and then stays down. It drops about 25 percent in the first 2 years.

Of all of the individual developments we investigated, the effect of faster dollar depreciation was clearly the most powerful. After a slight worsening in 1988, the nominal net export balance improved greatly in 1989 and 1990. By 1991, the reversal caused by the one-shot major depreciation had run its course. Then the nominal net export deficit began to worsen.

The reason for this is that in the basic model the effect of the differential in income growth here and abroad seems to be persistently negative. Thus, once the shift in prices is over, a worsening tendency sets in.

In 1992, the nominal deficit was still $122 billion smaller than its baseline value, and the real net export balance responded strongly to depreciation and turned into a surplus of $66 billion by 1992.

So of the three experiments, the front-loaded depreciation of the dollar is the one that really has the most effect; but even here, at the end there is a worsening tendency.

The results of a combination of all three experiments are also shown in tables 1 and 2 of the prepared statement. The numbers speak for themselves, so I will not read my prepared statement.

In summary, the results of the experiments indicate that none of the economic conditions we examined individually was able to undo the net export deficit in nominal terms. In combination, however, they were able to produce a very modest nominal net surplus by 1990. The surplus then begins to decline, however, and is turned negative by 1992. Looking at the experiments individually, and in order, the recession does not seem to have much effect at all; the foreign income growth has a little more effect; and the front-loaded depreciation has a strong effect but, again, tapering by the end of the period.

I have covered the basic points of the prepared statement and I would now be pleased to answer questions or comments on it.

[The prepared statement of Mr. Gramlich follows:]

PREPARED STATEMENT OF EDWARD M. GRAMLICH

Mr. Chairman, I am pleased to respond to your invitation to address the Joint Economic Committee and discuss conditions under which the current account deficit might improve. The Congressional Budget Office (CBO) has been concerned for some time with continued high current account deficits. Our concern, which we have expressed in the past in testimony before the Congress, is that depending on foreign capital to finance the deficits can potentially cause major economic disruptions if foreigners lose confidence in the U.S. economy. In recent weeks, we have seen what a loss of investor confidence can do to world stock markets. If foreign investors lose confidence in the United States because the current account deficit refuses to fall, we could see similar effects on foreign exchange markets leading to possible disruptions in the world economic and trading system.

Before I discuss what alternative economic conditions might produce a turnaround in our current account balance, let me briefly review how we arrived at the present deficit. The history of the 1980s shows that the deficit is the product not of one factor alone but of several acting together. As the United States recovered from the severe recession in the early part of the decade, its growth outstripped that of most of its trading partners. Together with an open U.S. market and an exchange rate rising for almost five years, the faster growth contributed to an abnormally rapid increase in imports and stagnant exports on a National Income and Product Account (NIPA) basis. The deficit we struggle with today is the result. Analysts generally believe that to reduce this deficit we must reverse one or more of the conditions that caused it.

Today, I would like to report on some experiments we have performed at CBO in recent weeks to find out what it will take for the current account deficit to turn around and then continue shrinking. I wish to emphasize at the outset that none of these experiments represents a CBO forecast of what will happen or when it may happen. The experiments are purely hypothetical investigations designed to answer questions such as: what would happen if there were a recession or if the dollar were to fall sharply over the next year?

In our investigations we examined three developments, each of which was expected to have a positive effect on net exports, the major component of the current account balance. We then compared their effects with the baseline deficit in our August updated forecast. The time frame we chose to examine was the present through 1992. The three hypothetical situations on which we based the experiments are:

- A typical recession in the United States with continued growth abroad;
- Faster economic growth in the rest of the world combined with a change in foreigners' preferences toward greater demand for U.S.-made exports; and
- A very rapid fall in the value of the dollar.

We also combined these three elements in an experiment to see what their joint effect on the current account balance would be.

THE BASELINE FOR THE EXPERIMENTS

Before I describe the experiments, let me say a few words here about the baseline used in our simulations. The baseline we used for evaluating all experiments was the net export path, which was broadly consistent with the CBO August updated forecast. Under this baseline forecast, the NIPA nominal net export deficit rises continuously from $110 billion in 1987 to $177 billion in 1992 (see Table 1 and Figures 1 and 2). In contrast, the real net export deficit declines from $123 billion to $84 billion over the same period.

Though the real and nominal balances in our forecast move in opposite directions, we cannot say that one of them is a more important indicator than the other. They are both valid indicators, and each tells us something different about the economy. An improvement in the real net export balance tells us that the trade-oriented part of the economy is strengthening. When the real balance improves, we are selling more goods abroad and buying fewer than previously. If we exclude from the balance agricultural exports and oil imports, two trade flows that often move erratically in the short run, the real deficit has fallen steadily for the last four quarters. Since real net exports is one of the key components of real GNP, a declining deficit adds directly to GNP growth.

Because of the fall in the value of the dollar that was needed to reverse the growth in the real net export deficit, we now pay more for many of the goods we still import. Moreover, since the dollar's fall has not reduced the quantity of imports enough to offset the rise in price, our nominal net export deficit continues to increase. The nominal balance gives us different information from the real balance: large nominal net export deficits generally mean large current account deficits that we must finance by borrowing from abroad. A continuous buildup of foreign debt from years of large current account deficits may be taken as a signal of weakness by the world foreign exchange and capital markets, leading to the loss in investor confidence I mentioned in my opening comments.

While it is the nominal net export and current account balances that I will focus on today, we should bear in mind that the real balance is already improving. Let me now discuss what we found out from each of the experiments.

EXPERIMENT I: RECESSION

In our first investigation, we examined the effect of a typical postwar recession starting in the first quarter of 1988. During this hypothetical recession, GNP falls for two quarters and grows only weakly in the third quarter of 1988, returning to its baseline level after about five years.

The effect of the recession, which is presented in Tables 1 and 2, is to produce a sharp improvement in both the nominal and real net export balances in 1988. The real net export balance then continues to improve except for a small reversal in 1990, but the nominal balance starts to deteriorate once again in 1989 and continues to worsen through 1992. By 1992, the net effect of the recession is to decrease the nominal deficit by only $9 billion and the real deficit by $7 billion compared with the baseline.

This behavior occurs because the recession lowers U.S. income temporarily, causing lower imports and lower borrowing from abroad. During the recovery, as U.S. income returns to its baseline level, imports would also grow rapidly. But even when income has caught up with its baseline level, the total stock of debt owed to foreigners will be about $80 billion smaller because of the imports forgone during the recession. In the long run, our interest payments to foreigners and our current account deficit will be smaller by the amount of the interest saved on the smaller debt.

From this first experiment, we conclude that a recession, unless it were of extremely severe proportions, would have only a slight permanent impact on the current account deficit.

EXPERIMENT II: FOREIGN GROWTH

In the second experiment, we investigated the effect of faster economic growth in the rest of the world. To achieve more rapid growth, we made foreign GNP increase one percentage point faster each year than we had forecast in our August report. I should point out again the purely hypothetical nature of this assumption. In fact, CBO does not consider it likely that the world will experience a permanent increase in the growth rate of such proportions. But we believe that it is useful to investigate what the net export balance would do if it happened.

In this same experiment, we also investigated the impact of a change in foreign tastes that would benefit U.S. exports. This change could arise, for example, as foreign purchasers become aware that the quality of U.S.-made goods has improved in recent years. To simulate the increased attractiveness of U.S. goods on world markets, we raised the income elasticity of demand for American exports by 20 percent. The income elasticity measures the percentage gain in foreign expenditures on U.S. exports when foreign incomes rise by 1 percent.

With a higher foreign income elasticity and the faster foreign growth, nominal net exports first improved slightly in 1988 but then continued to deteriorate, but at a slower rate than in the baseline (see Tables 1 and 2 and Figures 1 and 2). Real net exports improve

TABLE 1. NET EXPORT PROJECTIONS (In billions of current dollars and billions of 1982 dollars)

	1987	1988	1989	1990	1991	1992
Baseline						
Nominal net exports	-109.6	-112.9	-126.6	-144.5	-160.2	-176.6
Real net exports	-123.2	-102.1	-100.3	-101.0	-93.8	-83.9
U.S. Recession						
Nominal net exports	-109.6	-93.5	-102.7	-125.2	-145.7	-167.3
Real net exports	-123.2	-82.4	-77.6	-84.2	-82.3	-77.2
Increase in Foreign Growth						
Nominal net exports	-109.4	-108.4	-115.1	-124.5	-129.6	-133.0
Real net exports	-123.0	-97.7	-89.6	-83.3	-68.0	-48.9
Front-Loaded Depreciation						
Nominal net exports	-110.7	-113.4	-65.9	-25.0	-34.5	-55.0
Real net exports	-122.2	-65.2	30.7	77.9	75.2	66.4
Combined Experiments						
Nominal net exports	-110.7	-92.3	-34.2	10.2	6.2	-7.4
Real net exports	-122.1	-45.4	57.7	106.8	107.6	103.0

SOURCES: CBO estimates and Department of Commerce.

TABLE 2. NET EXPORT PROJECTION CHANGES FROM BASELINE
(Changes in billions of current dollars
and billions of 1982 dollars)

	1987	1988	1989	1990	1991	1992
U.S. Recession						
Nominal net exports	0.0	19.4	23.9	19.3	14.5	9.2
Real net exports	0.0	19.7	22.7	16.9	11.6	6.7
Increase in Foreign Growth						
Nominal net exports	0.2	4.5	11.5	19.9	30.6	43.6
Real net exports	0.2	4.4	10.7	17.7	25.8	34.9
Front-Loaded Depreciation						
Nominal net exports	-1.1	-0.5	60.7	119.5	125.7	121.6
Real net exports	1.1	36.9	131.0	178.9	169.0	150.2
Combined Experiments						
Nominal net exports	-1.1	20.6	92.4	154.7	166.4	169.1
Real net exports	1.1	56.7	158.0	207.8	201.4	186.9

Simulation Assumption Changes
(Expressed as percent difference
from base simulation)

	1987	1988	1989	1990	1991	1992
U.S. Recession						
Real GNP	0.0	-2.9	-3.1	-2.1	-1.2	-0.5
Increase in Foreign Growth						
Real foreign GNP	0.0	0.8	1.8	2.8	3.7	4.7
Front-Loaded Depreciation						
Real exchange rate	-2.2	-19.8	-25.0	-22.2	-19.4	-16.4

SOURCES: CBO estimates and Department of Commerce.

significantly in 1988 and then more slowly in subsequent years. By 1992, the nominal and real deficits would fall by $44 billion and $35 billion below the baseline values. It is worth keeping in mind that foreign tastes are not subject to U.S. policy prescription or even foreign government exhortation, as we have seen from the meager results of Prime Minister Nakasone's "Buy American" campaign. On the basis of our CBO experiments, we do not envision much help in reducing our current account deficit solely from changes in foreign tastes or even from changes in foreign income growth and tastes combined.

EXPERIMENT III: DEPRECIATION OF THE DOLLAR

The third development we investigated was a rapid drop in the real value of the dollar with respect to the currencies of our major trading partners. Over the last two-and-a-half years, the real value of the dollar has fallen substantially compared with the currencies of our trading partners in major industrial countries. The dollar has not fallen nearly as much against the currencies of our trading partners in developing countries, and evidence suggests that the disparity in the currency depreciation between the two sets of partners has caused U.S. importers to substitute imports from developing countries for imports from industrial countries.

In the third experiment, we investigated the impact on the net export balance if we speeded up our forecasted appreciation of the currencies of industrial countries against the dollar. We forced all of the appreciation to occur by the end of 1988, and then rapidly appreciated the currencies of our major developing country partners to catch up with the appreciation that had already occurred for the currencies of the industrial countries. Following 1988, currencies of all partners in developing countries followed the normal baseline path, although they started from a higher value against the dollar. The effect of these changes was to lower the overall real trade-weighted exchange rate by 25 percent by 1989.

Of all the individual developments we investigated, the effect of faster dollar depreciation was the most powerful. After a slight worsening in 1988, the nominal net export balance improved massively in 1989 and 1990. By 1991, the reversal caused by the one-shot major depreciation had run its course, and the nominal net export deficit began to worsen. By 1992, however, the nominal deficit was still $122 billion smaller than its baseline value (see Tables 1 and 2 and Figures 1 and 2). In constant dollars, the real net export balance responded strongly to the depreciation, with the real deficit turning into a $66 billion surplus by 1992.

COMBINED EFFECTS OF ALL THREE EXPERIMENTS

The three simulations I have just discussed show that reversing the causes of the deficit--by lowering growth in the United States compared with that abroad, by reversing the preference for foreign goods over American goods on world markets, or by lowering the high dollar--cannot individually turn around the deteriorating current account balance in the medium term. But since a combination of factors produced the deficit, it makes sense to seek its reversal by examining a combination of the three experiments.

We tested this hypothesis by examining a combination of the three conditions that produced a turnaround of the net export balance. By 1990, the balance was in surplus by $10 billion, though under the influence of increased income growth in the United States, the surplus shrank to a $7 billion deficit by 1992 (see Tables 1 and 2 and Figures 1 and 2). Again, the balance I have been discussing here is the National Income Accounts net export balance. Because of interest paid to foreigners and net unilateral transfers abroad (totaling about $50 billion by 1992), the current account balance--which includes these items--is never in surplus, even in this combination of experiments (see Table 3).

TABLE 3. CURRENT ACCOUNT BALANCES (In billions of current dollars) a/

	1987	1988	1989	1990	1991	1992
Base	-150.4	-159.2	-175.5	-195.8	-214.7	-234.4
U.S. Recession	-150.3	-139.8	-151.3	-175.8	-199.2	-224.1
Increase in Foreign Growth	-150.2	-154.9	-164.6	-176.7	-185.1	-192.2
Front-Loaded Depreciation	-151.7	-160.5	-117.9	-79.2	-90.0	-112.3
Combined Experiments	-151.4	-138.5	-85.5	-43.6	-49.1	-64.8

SOURCES: CBO estimates and Department of Commerce.

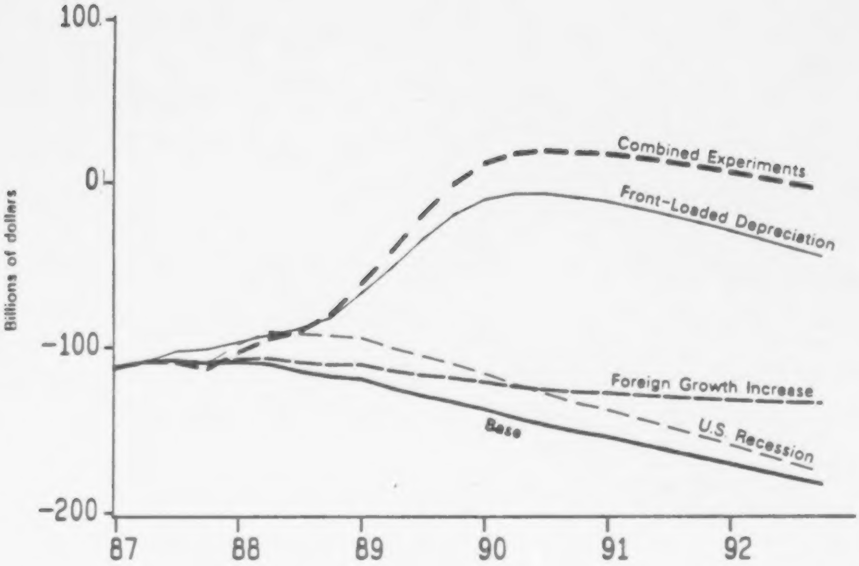
a. NIPA net export balance, adjusted to balance of payments definitions, plus net unilateral transfers (-), plus net government interest payments abroad (-).

CONCLUSION

Mr. Chairman, I wish to emphasize once again that the numbers I have presented today in this testimony are not CBO forecasts but are purely hypothetical exercises designed to evaluate the effects of alternative economic conditions on our net export balance. The results of our experiments indicate that none of the factors was individually able to undo the net export deficit. In combination, however, they were able to produce a modest surplus by 1990. But because so much of our national debt is now held by foreigners, the current account would remain in deficit until 1992 even under the most drastic assumptions. Under a combination of these changes in economic conditions, our net foreign debt would rise slowly. Without these changes, as Figure 3 illustrates, the debt would surge dramatically.

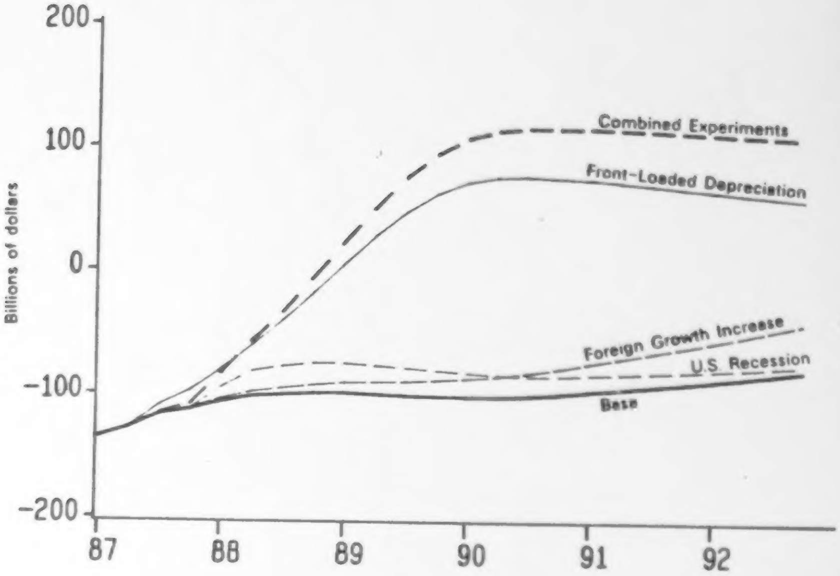
Thank you for this opportunity to present CBO's analysis of the prospects for reversing the current account deficit. I will be happy to answer any questions you may have on the subject.

Figure 1. Nominal Net Exports



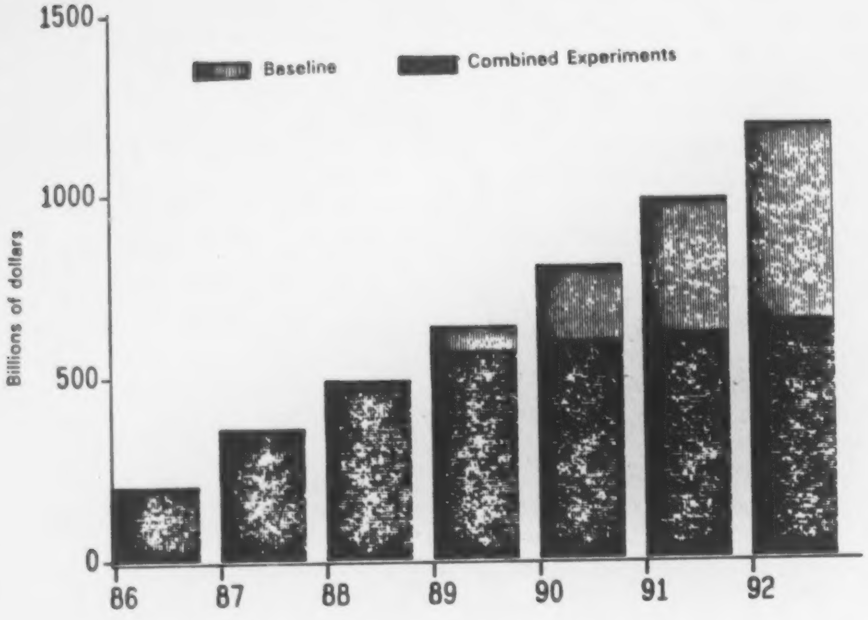
SOURCES: CBO estimates and Department of Commerce.

Figure 2. Real Net Exports



SOURCES: CBO estimates and Department of Commerce.

Figure 3. Net International Debt Position



SOURCES: CBO estimates and Department of Commerce.

Representative SCHEUER. Is your colleague testifying?

Mr. GRAMLICH. He has no proposed testimony. He is here in case you ask some questions about the technicalities of this simulation.

Representative SCHEUER. Congressman McMillan, do you have any questions?

Representative MCMILLAN. One question. I'll have to confess that I'm not totally up to speed on it. Would you elaborate a little bit more on the difference, so that all of us can understand it, between the real and the nominal? I think I understand it but I think a little elaboration on that would be useful.

Mr. GRAMLICH. Fine. The nominal refers to the value in current dollars or current currency terms. So, for example, if the dollar depreciates, then the price of imports rises and the quantity presumably falls. The quantity is measured in the real balance. So when the price rises and the quantity of imports falls, the real balance will improve because you're just looking at quantities there.

What happens to the nominal balance depends on the changes in price and quantity. That is, you have to compare the higher price with the lower quantity. So the nominal value of imports could either rise or fall. It depends on the relative magnitude of the two changes.

In this simulation, we have a falling dollar in the baseline. We have a falling dollar throughout the period and so the nominal value of imports turns out to be rising through the period. The real value of imports is also rising, but it is rising at a slower rate than exports, so the real trade balance moves toward equilibrium but the nominal does not.

I am not sure if that answers your question. It is slightly complicated. Basically, the nominal value includes the price shift and the real does not.

Representative MCMILLAN. OK.

Mr. GRAMLICH. And the relevance of it is that the real value is used in measuring this component of GNP—real exports minus imports. But the nominal balance of trade is the one we have to pay for. The nominal value determines the amount of our foreign borrowing and so forth. So it is not enough if the real balance is improving. We have to reduce the nominal balance too in order to limit our net borrowing.

Representative MCMILLAN. One thing that always troubles me a little bit—and we raised this the other day in taking a macro look at these things—is to not give proper weight to the fact that the trade deficit and, as a result of that, the payments deficit results in large part from a few sectors of the economy like oil. It's my understanding that without oil, we would have a net trade deficit of some $70 billion. Automotive and transportation would have a net trade deficit of somewhere in the range of $60 billion. I don't know what the figure is on agriculture, probably not best measured in terms of deficit but more in loss of export markets, which I think would be substantial. Then you have other industries like steel and textiles that perhaps run in the $10 to $15 billion range each in terms of net deficit.

But you take those four or five sectors together and they comprise a substantial portion of the trade deficit.

This kind of approach here doesn't make any particular attempt to address those particular sectors which in fact may end up having greater influence on the pattern of trade over the next 5 or 6 years than perhaps any macro considerations would. Or would that be a valid conclusion?

Mr. GRAMLICH. I think it actually does make an attempt to deal with that. First of all, the model is disaggregated and so we do measure the price and income elasticities and their effect on demand here and abroad. We measure those separately, commodity group, by commodity group, although not every last one. There is some aggregation, but we do attempt to go behind the aggregate figures to a certain extent when we perform the calculation. So our data can be examined by sector.

In my opinion, the relevant policy question is really not which sector is responsible. Obviously, in any large country like the United States we are going to find that some of our goods seem to compete very well in world markets and some of our goods do not, so you will typically have the deficit made up of large industries and goods like that.

But the relevant question for improving the trade deficit is the responsiveness at the margin. By that I mean a situation such as in the auto industry, where there is a big net deficit now but if either the dollar depreciates or we improve competitiveness the deficit could improve substantially. So that sector could be a big contributor to the improvement.

Thus, you have to look at these things with both of those considerations in mind and this model tries to capture all those aspects. There is some disaggregation in the model and the elasticities are a function of the situations in these various industries.

Representative MCMILLAN. Carrying that a little further, you may measure influences of exchange rates and so forth on, say, automobiles, and that's implicit in your model.

Mr. GRAMLICH. That's right.

Representative MCMILLAN. But there's nothing in there as to whether or not we make design engineering improvements which in turn improve the competitiveness of the product we are producing; or it wouldn't have in it any consideration of progress being made on the issue of agricultural subsidies worldwide that may dramatically change the agricultural equation, or other factors perhaps in the oil situation where our fate may rest more on independent decisions totally beyond our control with respect to the price of oil.

Mr. GRAMLICH. Yes. That is correct. This model and indeed any model that anybody ever tells you about has to use historical data, and whatever the rate of improvement of productivity was in the past or the agricultural productivity or whatever, that will tend to be extrapolated in the model. So we do nothing more than that. We look at the numbers and we make the best extrapolations that we can make.

So it is certainly true that if some of those things happen, that will improve things. That may be something that the committee and policymakers in general want to look at carefully. So you are certainly right about that.

Representative **McMillan**. I have no further questions at this point, Congressman Scheuer.

Representative **Scheuer**. Thank you very much, Congressman McMillan.

At the hearing last Friday, Stephen Marris recommended that we institute a cumulative 25-cent-a-gallon gas tax for 3 years, 25 cents for the first year, 25 cents the second, and 25 cents the third year. And that, in effect, we cut the budget deficit not by the Gramm-Rudman $23 billion a year but by $50 billion a year for at least a couple of years.

If this happens and if Congress really grasps the nettle and comes up with a major program of deficit reduction, both by cutting expenditures and by let us call it revenue enhancement—gasoline taxes, maybe a 1-percent tax increase across the board, maybe by deferring the reduction in taxes on the wealthy, perhaps by some kind of tax increase on alcohol, tobacco, and luxuries. What effect would this have on the U.S. economy and what effect would this have on the trade deficit and what effect would such a long-term program extending over a number of years have on the willingness of foreign investors to continue holding the dollar?

Mr. **Gramlich**. I'm happy to answer that, but I didn't hear your very first statement. What was changing 25 percent?

Representative **Scheuer**. Twenty-five cents a gallon on gas.

Mr. **Gramlich**. He wanted a gas tax of——

Representative **Scheuer**. A penny a gallon tax produces a little over $1 billion in revenue, so he's talking about increasing revenues from the gasoline tax alone of a little over $25 billion the first year, $50 billion the second, $75 billion the third. And we might add some other taxes into it. Some Congressmen are talking about a 1-percent increase across the board. Some of them are talking about alcohol and tobacco taxes, luxury taxes, deferring the reduction of taxes on the wealthy that's scheduled can be put in a holding pattern.

If we really come up with a long-term comprehensive package of deficit reduction, what would be the effect on the economy? What would be the effect on our trade deficit? And perhaps as important as anything else, what impression would this make on the markets, that impersonal 600 pound canary that's hovering up there. How would it work?

Mr. **Gramlich**. Well, obviously when you ask about complicated policies like that, I have to give cagey answers because I am not going to know this.

Representative **Scheuer**. Don't be cagey. Go with it.

Mr. **Gramlich**. Reducing the budget deficit a significant amount would be a good thing except for one caveat that I will get to. I will start with the main argument: the reason it would be a good thing is that the foreign borrowing demands of the U.S. economy would be reduced. These demands are currently consuming savings from the rest of the world and the removal of the borrowing demand of the Federal Government would improve the situation. That would tend to put some downward pressure on the dollar. It would tend to improve the trade deficit as well. So in terms of the testimony, we would be getting some of experiment 3, and we would be getting some of that improvement. But you would simultaneously be putting some downward pressure on the demand for foreign capital from the rest of the world. So that would tend to move us out of our current economic disequilibrium, although the potential for disequilibrium remains.

Representative Scheuer. Well, isn't this the name of the game?

Mr. Gramlich. That is the name of the game, but let me give the caveat. The caveat is that there is too much of a good thing in this. I really do not want to do anything to talk the Congress out of deficit reduction because I know it is hard for you.

Representative Scheuer. You really don't have to do anything to talk us out of it.

Mr. Gramlich. In the abstract, if the deficit were cut so much that it generated a U.S. recession, while you would get some benefits on the trade balance from that recession, you would have some other problems.

Representative Scheuer. What kind of deficit reduction would you worry might cause a recession at home?

Mr. Gramlich. There is no clear rule of thumb there, but we have actually thought about this a little and I think we are prepared to say that a problem does not occur until the deficit reduction reaches a figure near 1 percent of GNP. That is, $30 billion seems to be acceptable, as does $40 billion, although you might begin to start worrying about $40 billion. If you had $50 billion in 1 year, you might worry about it a little.

Representative Scheuer. Doesn't it matter where it comes from?

Mr. Gramlich. It does.

Representative Scheuer. Supposing we deferred the decrease in taxes on the ultrawealthy, people making over a couple hundred thousand dollars a year? Is that really going to put a crimp in the economy?

Mr. Gramlich. Well, even if we raised taxes on the rich there would probably be some——

Representative Scheuer. I'm not talking about raising taxes. I'm talking about deferring the scheduled reduction in taxes.

Mr. Gramlich. Well, raising taxes compared with the baseline experiments, deferring the scheduled reduction, even if you did that, you would have some impact on consumption. I am not going to tell you what it would be. It might be about one-half or two-thirds as much as at the lower end, but it would not be irrelevant.

Of course, you are right that it matters how you cut and some cuts would have a bigger impact than other cuts, and this is a very rough rule of thumb anyway. I do not want to sound overly precise here. You told me to go for it, so I am going for it.

Representative Scheuer. Right.

Mr. Gramlich. But to be sober about it, when the cut reaches a certain magnitude, the danger of recession is raised. Others will tell you that so I might as well, too. I think $30 billion would be safe.

Representative Scheuer. I really doubt whether Congress is going to pass the kind of package of revenue enhancement that's going to send us reeling into a depression.

Mr. Gramlich. That is right. So do I.

Representative Scheuer. The danger is that they will do too little and not too much.

Mr. **Gramlich**. Yes, I agree with that.

Representative **Scheuer**. Well, you gave us some interesting technical testimony this morning. What does that all mean to us, if you could sum it up, in terms of our policymaking role?

Mr. **Gramlich**. You hear many solutions offered for the problem of the trade deficit. You hear people honestly proposing that we need recession, but we are maintaining that a recession will not be useful and will have its own problems, as you know. You hear a lot of people saying that we ought to stimulate growth in other countries of our trading partners, but we are maintaining that, while that will do more than a recession, it still not going to solve the problem.

A solution of the problem in any finite period, for example, by 1992, requires, we think, a bigger downward depreciation of the dollar than we are including in the CBO baseline forecast. I think that it is probably safe to conclude—as indicated by this model and I think by other models—that there is no way out, at least when you look at the current account deficit, that doesn't involve significant depreciation of the dollar. I think that is the bottom line.

Representative **Scheuer**. A further depreciation?

Mr. **Gramlich**. A further depreciation, yes.

Representative **Scheuer**. How far is down?

Mr. **Gramlich**. Our third experiment assured something like 25 percent or 30 percent front loaded, happening immediately. We are prepared to believe that that number is speculative, that you have to allow some flexibility and fluctuation and it is difficult to do that. So I do not want to insist on a particular number, but I think a significant amount of depreciation is a necessary component.

Representative **Scheuer**. A further depreciation?

Mr. **Gramlich**. Yes. It is a necessary component of the solution.

Representative **Scheuer**. And you're not prepared to tell us how far down is down?

Mr. **Gramlich**. Well, I said 25 or 30 percent in this testimony.

Representative **Scheuer**. Congressman Wylie.

Representative **Wylie**. Thank you very much Congressman Scheuer.

I appreciate your being here, Mr. Gramlich, with you testimony. Have you been asked for any advice by those in the budget conference, the summit right now, as to what they should do to reduce the deficit?

Mr. **Gramlich**. Well, Congressman, we do not typically give advice. We typically produce the numbers and we have done that and are doing that for the budget conference. Every year we come out with a report on optional ways that the deficit could be reduced. We have approximately 150 options. The committees are well aware of that book and our list of options.

We are going to work harder on that book this year and come up with some new options. In that sense, we are giving advice, but we are not saying to the budget conference, "Why don't you do this, why don't you do that." They know that. I think they know what the possible remedies are.

Representative **Wylie**. They have a checklist of the possible remedies and it would be a combination of reductions in spending and/or tax increases in varying equations. Is that right?

Mr. **Gramlich**. Yes.

Representative **Wylie**. You haven't made a recommendation?

Mr. **Gramlich**. No, we typically do not make recommendations. We give options, just like the one we are presenting to you. We are not telling you to have a recession or to raise foreign growth. We are just giving you our estimate of what would happen if those events were to take place.

Representative **Wylie**. Well, in that connection, in your prepared statement you say that there could be improvement if the U.S. recession were taken into account, increase in foreign growth, if there was an increase in foreign growth the front-loaded depreciation factor was favorable, and then you have a combination there as to what could happen in the out year of 1992.

We haven't been able to do much in the way of increasing foreign growth so far.

Mr. **Gramlich**. That is right.

Representative **Wylie**. As a matter of fact, the West Germans have been a little sticky about that recently, as I understand the newspapers.

What if you took out that part of it? We don't have much to say about that, but we could have some influence over the other two factors you have in there.

Mr. **Gramlich**. Well, I am not able to produce the number right here, but it would be basically additive. What you would do is take table 2 in the prepared statement which is our exchange table and sum the U.S. recession and the front-loaded depreciation. Since by that time the U.S. recession has an almost insignificant effect, the important factor is front-loaded depreciation. So the estimate would be close to that for my front-loaded depreciation scenario.

Representative **Wylie**. Tell me what front-loaded depreciation is?

Mr. **Gramlich**. That means having the dollar decline 25 to 30 percent fairly soon, in the next 2 years.

Representative **Wylie**. So that's based on an assumption that the dollar is going to continue to decline in value?

Mr. **Gramlich**. That is just a hypothetical scenario: if the dollar were to decline, the trade balance should improve and we give you our estimate of how much.

There are some other problems, as everybody knows, if the dollar were to decline that rapidly. One problem is that it may stimulate some U.S. inflation in the meantime. We do not expect that would be long-lasting inflation, but there is a risk: and there would be some disturbance in financial markets that is very hard to quantify. So there would be some problems. I do not mean to say that this is a costless solution. But if you just look at the effect on the trade balance, this CBO's estimate of what might happen in response to such a depreciation

Representative **Wylie**. There was a big decline in the value of the dollar on the Japanese yen market yesterday.

Mr. **Gramlich**. That is right.

Representative **Wylie**. Is that good or bad?

Mr. **Gramlich**. Well, that moves us in the direction of experiment 3. I think it is good for the trade balance.

Representative **Wylie**. What effect does that have as far as foreigners' confidence in our economy is concerned?

Mr. **Gramlich**. I think that is hard to say, Congressman.

Representative **Wylie**. The reason I ask that is you say, "if foreigners lose confidence in the U.S. economy," and I'm trying to find out what would happen and how they are going to come to that? Should the foreigners lose confidence in our economy?

Mr. **Gramlich**. Well, confidence is a vague word. I think the stock market has taught us, if we did not already know, that it is hard to know what confidence means and what determines it. But you could argue both ways. You could say that as long as the U.S. accounts are as far out of balance as they are now, doing nothing about these large nominal net deficits and large current account deficits inspires a loss of confidence. That is one way to argue. Another way is to say that confidence is dependent on the dollar and if the dollar fell by the amount in our third experiment a loss of confidence would occur. "Confidence" is one of the all-time nonquantifiable imprecise words. You do not really know what it means.

So I am not going to give you a statement on what will or will not inspire confidence in the U.S. economy, but I do think that as long as we do nothing about our deficits there is a potential for loss of confidence because people do not believe it is possible to continue in this way.

Representative **Wylie**. And the biggest potential for loss of confidence is the budget deficit; is that right?

Mr. **Gramlich**. I think it is certainly an important factor; as long as the budget deficit is large, it is certainly an important component of the savings imbalance. It is really an imbalance that we do not save enough for the investment demand we have in this country and that is certainly a large component of the negative savings. As long as we lack real progress on reducing the budget deficit, I think the risk that matters will reach a crisis is magnified.

Representative **Wylie**. In your prepared statement, you talk about current account balances. Now what impact would your combined experiment have on the merchandise trade account by 1992?

Mr. **Gramlich**. I will have to turn that one over to Stephan.

Mr. **Thurman**. While I search through my tables I will tell you that in most of these exercises with respect on the exchange rate, the greater impact is on trade. Off the top of my head, I would tell you it is probably two-thirds to three-quarters of the net change and I hope that by the time I get to the appropriate table I can assure you of that.

Yes. Of the $169 billion nominal change, $122 billion of that is on trade, sir.

Representative **Wylie**. So how do you answer my question? What impact would that have on the merchandise trade account on your combined experiment?

Mr. **Thurman**. The combined experiment with respect to change in the exchange rate?

Representative **Wylie**. Right.

Mr. **Thurman**. That is what I said, sir. That was a change of $122 billion from the baseline by 1992. That is an improvement in the trade account of $122 billion.

Mr. **Gramlich**. It is about three-quarters of the improvement shown on table 2 in the prepared statement.

Representative **Wylie**. Which direction should we take here to try to improve our trade balance? Should we try harder to increase exports, to have massive exports, or should we try harder to reduce imports, or is that not a good question? I guess the answer is we should try harder to increase the exports.

Mr. **Gramlich**. Let me answer your question in a different way. I think we should do both, but in the right way. The right way is to make the economy more competitive. Then we could both stimulate exports and reduce imports because our own industries would be more competitive here and abroad.

We would have real reservations about doing that in what we consider to be an unproductive way. Trade protection would create a very different world where other countries could retaliate. It is not clear what would happen with a trade protection approach and it is also not clear how lasting an improvement brought about in this way would be.

So I think that both exports and imports are something we could profitably work on, but in my opinion there is a good way and a bad way to do that.

Representative **Wylie**. The reason for my question is, there is a trade bill now going to conference supposedly. It has passed the House and it's going to conference now. The thrust of that trade bill is to reduce imports, isn't it?

Mr. **Gramlich**. Yes.

Representative **Wylie**. In an effort to make a net impact on the current account, and your feeling is that that's probably the wrong direction.

Mr. **Gramlich**. I do not want to take a position on the bill itself, but I think it carries a risk that imports appear to be reduced, but if retaliation is inspired exports may be reduced as well, and a difficult world trade environment will have been created.

There are arguments that if the trade bill threatens to reduce imports, exports can be increased. I have heard no clear evaluation of those arguments, but if that is true, and if we can threaten to reduce imports by protectionism but not actually do it, then that may be a desirable outcome as well.

Representative **Wylie**. Thank you, Mr. Gramlich. I have no further questions.

Representative **Scheuer**. Thank you very, very much, Mr. Gramlich. We appreciate your testimony.

Mr. Gramlich, let me just ask you one question before you go. We hear a lot about the Smoot-Hawley tariff and members like myself who have voted against the trade bill have invoked the spirit of Smoot-Hawley. Is that logical? Is it fitting? Is it appropriate? Is it relevant to——

Mr. **Gramlich**. To invoke the spirit of Smoot-Hawley?

Representative **Scheuer**. Yes.

Mr. **Gramlich**. I am not an economic historian and the argument is made that Smoot-Hawley was responsible for taking the stock market decline and turning it into a great depression. I must say that, even though had I been alive at the time I hope I would have voted against Smoot-Hawley, I am not sure that it was responsible for all that damage. I think that would be hard to prove.

There were certainly many other things that contributed to the Great Depression at that time.

On the other hand, I cannot believe that it was wise to impose a trade protection tariff in 1930, nor that a similar measure would be wise now.

Representative **Scheuer**. Thank you very, very much. We very much appreciate your testimony.

All right. We will now call up the next panel. Mr. Martin Abel, president of Abel, Daft & Earley; Mr. Roger Bird, vice president, international services, Wharton Econometrics; and Mr. Stephen Roach, senior economist, Morgan Stanley.

We're very happy to have this very distinguished panel. Your prepared statements will all be printed in full in the record, so we hope that you will chat with us informally and don't hesitate to refer to anything that you have heard this morning either from this side of the table or the witnesses' table. So we will start with Mr. Abel. Please take your 8 or 10 minutes and proceed.

STATEMENT OF MARTIN E. ABEL, PRESIDENT, ABEL, DAFT & EARLEY

Mr. **Abel**. Thank you very much, Congressman Scheuer.

My statement is brief and I will try to keep the summary brief as well.

Agricultural trade has experienced very wide cyclical swings since 1970. The numbers in a sense speak for themselves. In the early 1970's, we exported about 8 billion dollars' worth of agricultural products and imported $6 billion, and had a positive trade balance of about $2 billion.

The combination of events in the 1970's including a depreciating dollar, policy changes and other factors abroad, and some poor weather helped boost our exports to a record of nearly $44 billion by fiscal 1981. And, while our imports continued to grow in this period, the net trade balance expanded to nearly $27 billion by fiscal 1981. Since that time——

Representative **Scheuer**. Excuse me. Is that a deficit?

Mr. **Abel**. A surplus. Agriculture has consistently in recent times——

Representative **Scheuer**. This is the agricultural trade balance.

Mr. **Abel**. I'm just talking about the agricultural trade balance, right. In fact, all my comments are going to be limited to agriculture.

In the 1980's, we saw very serious deterioration in the net trade surplus in agriculture which fell from $27 billion in 1981 to about $5.5 billion in fiscal 1986, and we now see a slight increase in that surplus in fiscal 1987.

The major factors in the 1980's that hurt us were, first of all, a world recession in 1982 combined with financial and economic problems in a lot of developing countries that slowed total world agricultural trade. But, in addition, we lost market share very precipitously, and I give some numbers that illustrate how we've lost market share. The loss of market share can be attributed: One, to the strengthening of the dollar in the first half of the 1980's, and two, to a set of domestic agricultural policies and programs that artificially held our prices well above what our competitors were willing to sell at.

In addition to the recent decline in the dollar, probably the most significant new factor has been the change in agricultural policy that is embodied in the Food Security Act of 1985, which allowed the United States to do two things—to drop its price support and therefore the market prices for major agricultural commodities very sharply, and to be more aggressive in the use of export assistance program. You can read that as export subsidy programs of one kind or another, whether it's food aid or credit programs or what have you.

And we are beginning to see the effects of that policy—we are now into the second year of it—working to increase our agricultural trade surplus. Now in any one year in agriculture with weather being freaky all over the world, you can't read everything into policies or economic events, but I am reasonably optimistic, but with one major caveat, about the outlook for agricultural trade.

I think there is a basis for our exports continuing to expand. Our imports will probably continue to expand, although imports will be tempered by a weaker dollar. But I think there's a basis for agricultural exports to outspace agricultural imports and for further growth in the trade balance, provided the world economy doesn't fall apart. And that's a big caveat and I can't sit here today and tell you whether it's going to fall apart or it isn't going to fall apart. But if the recent turmoil that we've seen in financial markets ultimately gets translated into a major world recession, then I think all bets are off in terms of what I'm saying.

Economic growth is important. But there are a couple other things that I'd like to mention beyond economic growth on a world scale, things that are going on that look a little bit more favorable for agriculture, and it's basically a combination of things where demand globally is starting to outpace supply.

We have some areas of the world that are very significant where they have been able to achieve very good economic growth rates while at the same time their rate of growth in agricultural production has been slowing down. I would say that China is probably the best example of that. And if China can sustain an 8 or 10 percent real rate of growth each year, the pressure will be on for China to further reduce its exports—it's both an exporter and an importer—and to increase its imports with imports being constrained by how much money they want to spend, not by the pentup demand in the economy.

Another case, which is a little different because it has both pluses and minuses in it, is the Soviet Union. Clearly, the Soviet Union is making progress in increasing agricultural output, particularly grains. I think people are coming to believe that that's real. We're not sure how much further that process can go, but there's something real going on. So the prospects for grain exports to the Soviet Union aren't probably that bright.

However, they also want to increase meat and poultry and dairy production as a matter of stated policy. They want to improve feeding efficiency. And while they are reducing grain exports, they are increasing very sharply their imports of protein feeds which are needed to improve the efficiency of livestock production. So we have a very interesting situation where Soviet agricultural imports may remain at a high level but the mix may change very dramatically.

The final point that I would make is that you probably in the past heard about the green revolution that took place in developing countries—new varieties of wheat and rice and other commodities that led to very substantial increases in production in those countries. Evidence is beginning to accumulate that the rate of growth in output in developing countries is decreasing and the green revolution effect is playing itself out. Developing countries will probably not be able to increase their agricultural production, particulary grain production, as rapidly in the future as they did in the late 1960's and 1970's.

The implications of that are twofold. One, for the developing countries that have got some money, they will probably rely more heavily on imports. That is the case for countries such as Malaysia, Korea, Taiwan, and even countries like India and Thailand where the domestic demand is growing. For the poor countries who are also likely to experience poor economic growth, if they are going to import more, it almost has to be with some kind of aid. And whether or not the United States is willing to provide that aid is a key factor in how our export performance will go with respect to the poorest of the poor countries.

That very quickly summarizes my prepared statement and basically, if the world economy doesn't fall out of bed, I think we will see agricultural exports growth outpacing growth in imports and the positive trade surplus that we've had in agriculture will continue to increase over the next few years.

[The prepared statement of Mr. Abel follows:]

PREPARED STATEMENT OF MARTIN E. ABEL

THE OUTLOOK FOR U.S. AGRICULTURAL TRADE

Background

U.S. agricultural trade has experienced major cyclical swings since 1970. Exports were about $8 billion a year in the early 1970's. A combination of world crop problems, strong world demand for food and fiber, and a declining dollar boosted agricultural exports to a record $43.8 billion by fiscal year 1981. Thereafter, U.S. exports declined sharply, falling as low as $26.3 billion in 1986. This drop resulted from a combination of world economic problems and a loss of U.S. market share due to a strong dollar and high domestic price supports. Export performance improved slightly in fiscal year 1987.

The path of agricultural imports has been much more orderly than that of exports. Imports have trended upward at a fairly steady pace from about $6 billion per year in the early 1970's to about $21 billion in recent years. The growth in imports has been driven primarily by domestic income and population growth, but a strong dollar also contributed to import growth in the first half of the 1980's. Imports consist of commodities and foods that are generally not produced in the U.S., as well as commodities and foods that compete with domestic production. Imports classified as competitive account for about two-thirds of total agricultural imports and complementary imports account for one-third. These shares have been quite stable in the 1980's.

The U.S. has consistently been a net agricultural exporter over the past twenty years or so. Net exports increased from about $2 billion a year in the early 1970's to a record of nearly $27 billion in 1981. They then declined to slightly over $5 billion in 1986, the lowest level since 1972, and recovered slightly to the $7.5 billion level in 1987.

The policy and economic factors that explain the historic performance of U.S. agricultural trade are now generally understood and I will not review them here. Rather, I want to focus on the agricultural trade outlook for the next few years and some of the key factors behind that outlook.

Statement by Martin E. Abel, President, Abel, Daft & Earley, to the Joint Economic Committee, Congress of the United States, November 5, 1987.

U.S. Agricultural Trade

Fiscal Year	Exports	Imports	Net Balance
	billion dollars		
1970	7.0	5.7	1.3
1971	8.0	6.1	1.8
1972	8.2	5.9	2.3
1973	15.0	7.7	7.2
1974	21.6	10.0	11.5
1975	21.8	9.4	12.4
1976	22.7	10.5	12.2
1977	24.0	13.4	10.6
1978	27.3	13.9	13.4
1979	32.0	16.2	15.8
1980	40.5	17.3	23.2
1981	43.8	17.2	26.6
1982	39.1	15.5	23.6
1983	34.8	16.4	18.4
1984	38.0	18.9	19.1
1985	31.2	19.7	11.4
1986	26.3	20.9	5.4
1987 Est.	28.0	20.5	7.5

Policy Changes

The Food Security Act of 1985 recognized the importance of agricultural exports to the economic health of American agriculture and provided a policy framework for the U.S. to become more competitive in world markets and to stimulate export growth. Market prices of basic commodities have declined significantly over the past two years. In addition, export credits and subsidies have been used aggressively so that for some commodities world prices have been kept below those in the domestic market. Exports have also benefited from a decline in the value of the dollar.

Progress is being made to increase both the volume of U.S. exports and our share of world trade, as shown in the following table. One has to be careful not to attribute all of the increases experienced so far or expected in the near future to policy changes since weather problems in other parts of the world as well as world economic growth have also contributed to a rebound in export volumes.

U.S. Agriculture Exports and Share of World Trade

	Export Volume					U.S. Share				
Crop Year	Wheat	Coarse Grain	Soybeans	Cotton	Rice	Wheat	Coarse Grain	Soybeans	Cotton	Rice
	mmt					percent				
1980/81	41.9	72.4	21.8	1.3	3.0	45	69	81	30	22
1981/82	48.8	58.4	25.3	1.4	2.7	49	60	95	32	22
1982/83	39.9	54.0	24.7	1.1	2.4	41	60	86	26	20
1983/84	38.9	55.8	20.3	1.5	2.2	38	61	78	36	18
1984/85	38.1	57.2	16.3	1.3	2.0	36	56	65	29	18
1985/86	24.9	36.6	20.1	.4	1.9	26	38	77	9	15
1986/87	27.3	46.9	20.7	1.5	2.7	27	47	73	27	21
1987/88 Est.	33.3	49.1	19.0	1.5	2.6	32	49	70	29	25

But progress has been much slower so far in improving the value of agricultural exports because gains in export volume have been largely offset by lower unit prices.

We see the U.S. remaining price competitive in world markets over the next few years. Agricultural surpluses measured in terms of both stock levels and acreage idled under government programs will work to keep U.S. prices relatively low, although further declines in support levels and market prices are likely to be modest. In addition, we expect the value of the dollar to remain low relative to other major currencies. These prospects should lead to further improvements in the U.S. share of world trade for major agricultural commodities.

Prospects for World Agricultural Trade

The next question is what will happen to world trade levels. I see three sets of forces that will bear on world trade levels.

- World economic growth prospects.
- Policy changes in other countries.
- Prospects for increasing production in developing countries.

Prospects for World Economic Growth

A key factor determining U.S. agricultural exports over the next few years will be the performance of the world economy. One lesson we learned in the 1980's is that world agricultural trade levels are sensitive to economic conditions, and trade in some commodities is more sensitive than others.

Trade in basic foods such as wheat, rice, and vegetable oils tends to be less sensitive to fluctuations in income. Even in difficult times people need basic foods and governments import them if they are needed.

Demand for feeds (grain and protein) is much more sensitive to income. Consumption of meats, poultry, and dairy products around the world is fairly responsive to income. The same is also true for industrial agricultural products such as cotton.

The combination of a world recession in the early 1980's and the debt problems of developing countries that adversely affected their economic performance and ability to import had a profound impact on world trade for basic commodities. World trade either stagnated or declined sharply in the case of coarse grains as illustrated in the following table. Sustained growth in the world economy since 1982 has resulted in improved demand for agricultural products and expanding trade levels. But this growth is modest compared to the rapid expansion in trade experienced in the 1970's.

World Trade

Year	Wheat	Coarse Grain	Soybeans	Cotton	Rice (milled)
	- - - - - -	- - - - - - -	mmt - - - -	- - - - - -	- - - - -
1980/81	93.8	105.4	27.0	4.3	13.7
1981/82	99.3	96.6	26.5	4.4	12.3
1982/83	100.0	89.9	28.6	4.3	11.8
1983/84	102.0	91.7	16.1	4.2	12.3
1984/85	107.0	102.4	25.2	4.5	11.2
1985/86	96.0	95.3	26.1	4.5	12.5
1986/87	102.1	99.1	28.5	5.5	12.6
1987/88	103.1	98.9	27.0	5.2	10.2

The recent turmoil in financial and equity markets makes the world economic outlook for the next few years highly uncertain. If financial problems can be contained so that the world econony can continue to grow, then the outlook for world agricultural trade and U.S. exports will be promising. The U.S. would continue to benefit from both growth in world trade and further improvements in its share of that trade. If, however, recent economic developments lead to a world recession, U.S. export growth could slow and we might even see a decline in export volume.

Demand Outpacing Production

We are beginning to see evidence that the growth in the demand for food is outpacing production growth in a number of countries. In some cases the imbalance is due primarily to strong economic growth. In others, it is due to a slowing of the rate of growth in production.

China is a case where very rapid economic growth in recent years has resulted in that country increasing its imports and decreasing its exports of basic agricultural commodities. If that growth pattern persists, China will become more dependent on imports, with import levels being driven more by how much money it wants to spend on agricultural imports than by food needs.

The Soviet Union is also undergoing interesting changes in the area of food and agriculture. It appears to be making real progress in increasing grain production as a result of a number of policy changes that have lead to improved production practices. These developments, in themselves, willl have a negative impact on world grain trade. At the same time, however, the Soviets are intent on increasing meat, poultry, and dairy production though improvements in feeding efficiency based on greater use of protein feeds. The Soviets have increased imports of protein meals sharply. Imports in 1986/87 were at a record 2.7 million metric tons, exceeding the previous record of 2.4 million metric tons in 1982/83. Estimates for 1987/88 protein meal imports are in the 3.5-5.0 million metric ton range. If recent policies continue, the USSR will continue to be a substantial importer of agricultural products, but these imports are likely to favor protein feeds over grains.

In a number of developing countries there is evidence that the "green revolution" impact on grain production is playing itself out and the rates of growth in yields has slowed significantly. More affluent developing countries in Asia, Latin America and parts of Africa that continue to experience good economic growth but slower growth in agricultural output will have to rely more on imports and they should be able to pay for larger imports. Poorer developing countries with both poor economic and agricultural output performance will probably not represent commercial growth markets. Some of them might become more reliant on food aid. But growing food aid needs will only benefit U.S. exports if we are willing to increase food aid assistance.

Summary

Continued world economic growth is essential if world and U.S. agricultural trade are to expand over the next few years. If such growth is realized, we expect U.S. exports to expand at a modest but healthy rate. World and U.S. exports will also benefit from policy changes to improve food availabilities in countries such as China and the USSR and from a slowing of growth in agricultural production in a number of developing countries. In addition, a weak dollar and relatively low market support levels for agricultural commodities in the U.S. should lead to further improvements in the U.S. share of world agricultural trade.

With the bulk of the price declines behind us, future growth in U.S. export volumes will be closely matched by increases in the value of our exports.

We expect agricultural imports to continue to grow roughly in line with past trends.

On balance, then, the value of U.S. net agricultural exports should continue to increase. It is highly unlikely, however, that net exports will, over the next few years, approach the high levels achieved early in this decade.

Senator **Sarbanes** [presiding]. Thank you very much.
Mr. Bird, please proceed.

STATEMENT OF ROGER BIRD, VICE PRESIDENT, INTERNATIONAL SERVICES, WEFA GROUP

Mr. **Bird**. Thank you. It's a pleasure to be here. My name is Roger Bird. I'm the vice president for international services in the WEFA Group, and I have been asked to analyze the U.S. trade position and growth rates by region as well as to assess the likely changes in their nominal trade balance with each major region over the next several years.

I'm going to add something to this testimony in that I will be giving a distinction between trade by region as well as by major commodity group, so that you will not only be looking at trade with Japan in total but also by manufactured goods and primary commodities, such as Mr. Abel's testimony was addressing.

I have a prepared statement and the figures and tables in the appendix illustrate the results of our current base case forecast, the world economic outlook of October 1987, which was generated essentially in the month of September—therefore, precrash results.

These results are shown to you in terms of total and bilateral trade position. Table 1.1 in the appendix summarizes the forecast for the next 5 years and, in brief, it shows a slow growth world economy of about 2.9 percent with a weaker dollar and slightly higher inflation. The U.S. counterpart to that growth is a growth of the United States of approximately 2.8 percent.

That gap, incidentally, between 2.9 and 2.8 percent, is a reflection of the relative opportunity for the United States. In the recent past, U.S. growth relative to outside growth has been much higher than that.

Compared to potential, the United States is still expected to grow relatively faster than the rest of the world. That is, we are closer to potential growth than the rest of the world. And this is especially so with regard to some of our principal export markets. That's Canada, Latin America, and the Middle East, and that is shown in table 2.2.

In this world economic environment, the U.S. payments and trade position over the next 5 years may be characterized by six major points.

First point. In spite of the substantial fall of the dollar back to 1980 levels by 1988–89, neither nominal current account balances nor nominal merchandise trade balances will improve much in the medium term. This is shown in figures 1 and 2.

The trade account improves by $33 billion, but the current account by only $22 billion. Both accounts would improve much more if the energy trade balances did not substantially deteriorate by some $46 billion. We are rapidly returning to the trade structure position of the United States in the late 1970's when the merchandise trade deficit was entirely due to OPEC. It was a deficit of $38 billion in 1980 which would account for the entire deficit in 1980.

Second point. In real terms, there is steady improvement in the U.S. merchandise trade position by some $79 billion in the 1980's prices. This is shown in figure 3. It's barely sufficient to counter the J curve effect of the declining dollar, a slow growth of many of our export markets, and a deterioration of our current balance of services and factor payments which alone accounts for a loss of about $10 billion.

A similar and less exaggerated movement in the opposite direction is already occurring in Japan, the country with whom we continue to have the largest merchandise trade deficit. It's still negative $40 billion in 1992, which is down a bit from $49 billion in 1987.

Third point. Our bilateral trade balances in manufactured goods improve with all of our major trading partners. In manufactured goods, our deficits improve with all major trading partners by 1992, as shown in figure 4. The improvement is most pronounced with Latin America and the Middle East in the so-called "rest of world" group, while we barely hold our own with regard to Japan and the developing Pacific Rim countries, including the NIC's in the Pacific Basin countries. Here I want to add the Pacific Basin includes eight countries—the NIC's—Korea, Taiwan, Hong Kong, Singapore; as well as the smaller countries of the ASEAN group—Malaysia, Thailand, Indonesia, and the Philippines. In these Pacific Basin countries, Taiwan and Korea retain their current net surplus positions with us while their own positions deteriorate vis-a-vis Japan.

We were a net surplus country in 1980 in manufactured goods trade by some $20 billion. We do not return to this status of surplus in manufactured goods until the late 1990's under our current base case assumption.

Fourth point. We get some further relief from our traditional export surplus position in primary nonenergy commodities, just as Mr. Abel has mentioned. This improves from our current status everywhere, especially with Japan and Canada. This is shown in figure 5. This assumes that in spite of increased competitiveness of Brazil, Argentina, and Australia, our export potential in agricultural goods improves due to our more market oriented prices and reductions in trading-partner import restrictions.

Fifth point. Even to accomplish these fairly modest improvements, our exports must grow very fast compared with imports in order to overcome our initial 1987 condition, wherein imports are today 66 percent larger than exports. This is shown in appendix tables 1 through 3.

For example, our total nominal manufactured goods exports grow at 12.6 percent compounded rate compared with 5.5 percent for imports. With Japan, the difference will be even more striking. We expect 15.7 percent for exports, 4.6 percent for imports. This means that the growth of U.S. domestic demand, especially consumption expenditures, must take a back seat to U.S. net export demand with regard to our trading partners if we are to steadily work our way out of the hole into the 1990's.

Sixth point. The most discouraging problem is the deterioration of our energy trade balances. These energy trade balances deteriorate nearly everywhere, if you look at table 4. Entirely unlike the situation with regard to manufactured goods and other primary commodities, our exports will be growing at only a 5.1-percent rate while our imports will be growing at a 14.5-percent rate.

In conclusion, the fall of the dollar helps our position but not by much, and not by enough to counter the slow growth in our main traditional export markets, the loss of our services and factor payment surplus as we become a debtor nation, the increase in our energy imports, and our initial condition of imports being 66 percent larger than exports.

I would be pleased to answer any questions. I want to thank you for the opportunity to give this testimony.

[The prepared statement of Mr. Bird follows:]

PREPARED STATEMENT OF ROGER BIRD

EVALUATION OF PROSPECTS FOR U.S. EXPORTS AND IMPORTS TESTIMONY BEFORE JOINT ECONOMIC COMMITTEE

Thursday, November 5, 1987

My name is Roger Bird. I am the Vice President for International Services in The WEFA Group--which is one of the largest macroeconomic forecasting and consulting firms in the United States.

I appreciate the opportunity to appear before The Joint Economic Committee at this critical juncture in our nation's economic and trade performance.

I have been asked to analyze the United States' trade position and growth rates by region, as well as to assess the likely changes to our nominal trade balance with each major region over the next several years.

The figures and tables in the appendix illustrate the results of our current base case forecast, World Economic Outlook, in terms of total and bilateral trade positions. Table 1.1 summarizes the forecast for the next five years, a slow growth world economy (2.9%) with a weaker dollar and slightly higher inflation. Compared to potential, the United States is still expected to grow relatively faster than the rest of the world--and this is especially so with regard to some of our principal export markets: Canada, Latin America, and Middle East (see Table 2.2).

In this world economic environment, the U.S. payments and trade position over the next five years may be characterized by six main points:

1) In spite of the substantial fall of the dollar back to 1980 levels, neither nominal current account balances nor nominal merchandise trade balances will improve much in the medium term (see Figures 1 and 2). The trade account improves by $33B, but the current account by only $22B. Both accounts would improve much more if the energy trade balances did not substantially deteriorate by some $46B. We are rapidly returning to the trade structure position of the late 1970s when the merchandise trade deficit was entirely due to OPEC (a deficit of $38B in 1980).

2) In real terms, there is steady improvement in the U.S. merchandise trade position by some $79B in 1980 prices, (Figure 3) but this is barely sufficient to counter the J-curve effect of the declining dollar, the slow growth of many of our export markets, and the deterioration of our current balance in services and factor payments (a loss of at least $10B). A similar less exaggerated movement in the opposite direction is occurring in Japan--the country with whom we continue to have the largest merchandise trade deficit (still -$40B in 1992 down from -$49B in 1987).

3) Our bilateral trade balances in manufactured goods improve with all of our major trading partners (see Figure 4). The improvement is most pronounced with

Latin America and the Middle East (in the "Rest of World" group), while we barely hold our own with regard to Japan and the developing Pacific Basin countries. In the latter set, Taiwan and Korea retain their current net surplus positions with us while their own positions deteriorate vis-a-vis Japan. We were a net surplus country in 1980 in manufactured goods trade by some $20B. We do not return to this status until the late 1990s under our current base case assumptions.

4) We get some further relief from our traditional export surplus positions in primary (nonenergy) commodities, which improve from our current status everywhere especially with Japan and Canada (Figure 5). This assumes that in spite of increased competitiveness of Brazil, Argentina and Australia, our export potential in agricultural goods improves due to our more market-oriented prices and reductions in trading partner import restrictions.

5) Even to accomplish these fairly modest improvements, our exports must grow very fast compared with imports in order to overcome our initial 1987 condition wherein imports are 66% larger than exports (as shown in Appendix Tables 1-3 of The WEFA Bilateral Trade Outlook). For example, our total nominal manufactured goods exports grow at a 12.6% compounded rate compared with

5.5% for imports. With Japan, the difference will be even more striking--15.7% for exports versus 4.6% for imports. This means that the growth of U.S. domestic demand (especially consumption expenditures) must take a back seat to U.S. net export demand with regard to our trading partners, if we are to steadily work our way out of the hole into the 1990s.

6) The most discouraging problem is the deterioration of our energy trade balances nearly everywhere (see Table 4). Entirely unlike the situation with regard to manufactured goods and other primary commodities, our exports will be growing at a 5.1% rate while our imports will be growing at 14.5%.

In conclusion, the fall of the dollar helps our position but not by much and not by enough to counter:

- slow growth in our main traditional export markets;
- loss of our services and factor payments surplus as we become a debtor nation;
- increases in our energy imports;
- our initial condition of imports 66% larger than exports.

I would be pleased to answer any further questions. Thank you.

FIGURE 1

UNITED STATES

EFFECTIVE EXCHANGE RATE VS CURRENT ACCOUNT BALANCE

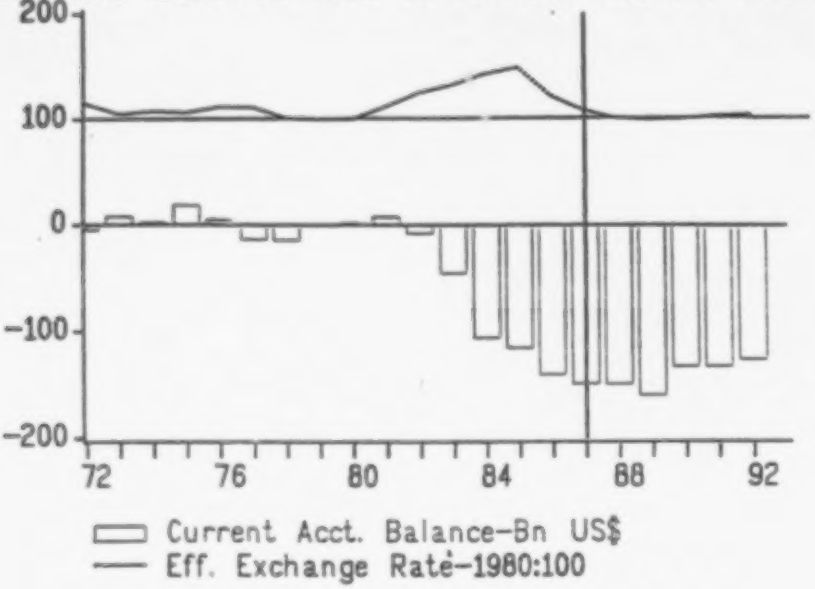


FIGURE 2

UNITED STATES

EFFECTIVE EXCHANGE RATE VS MERCHANDISE TRADE BALANCE

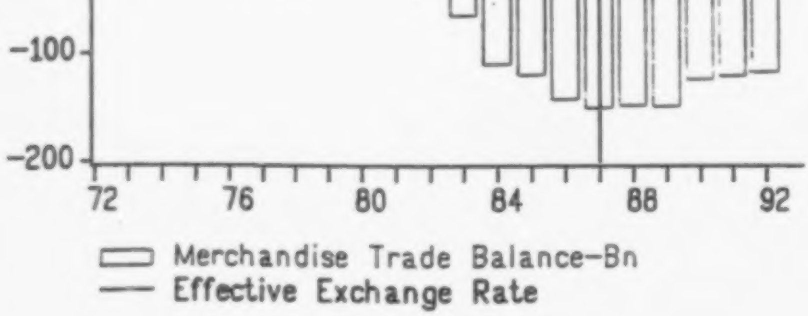


FIGURE 3

REAL TRADE BALANCES VS CURRENT ACCOUNTS

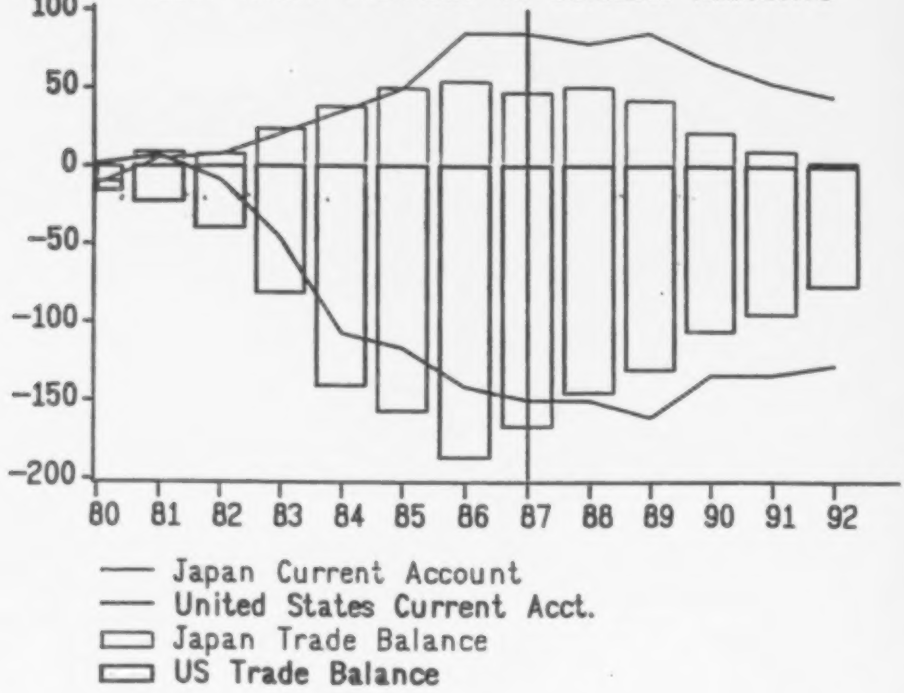


FIGURE 4

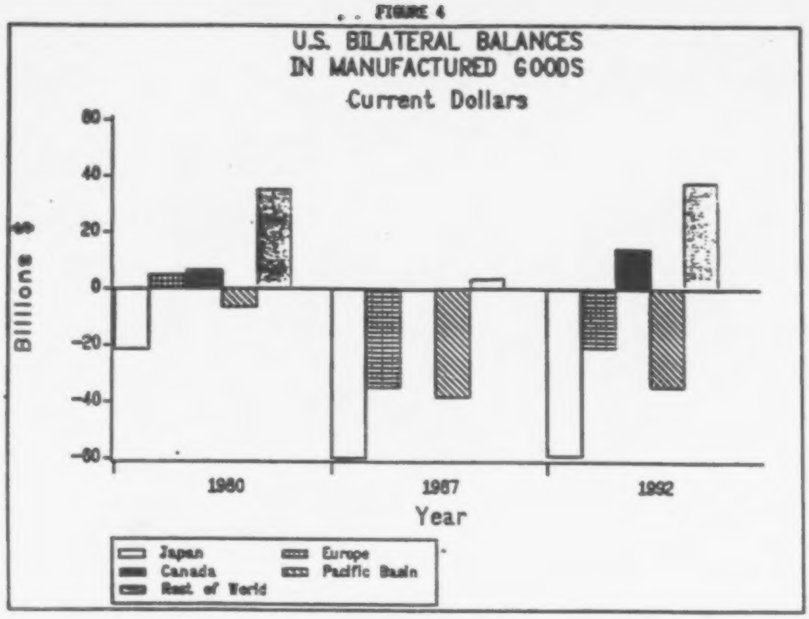


FIGURE 5

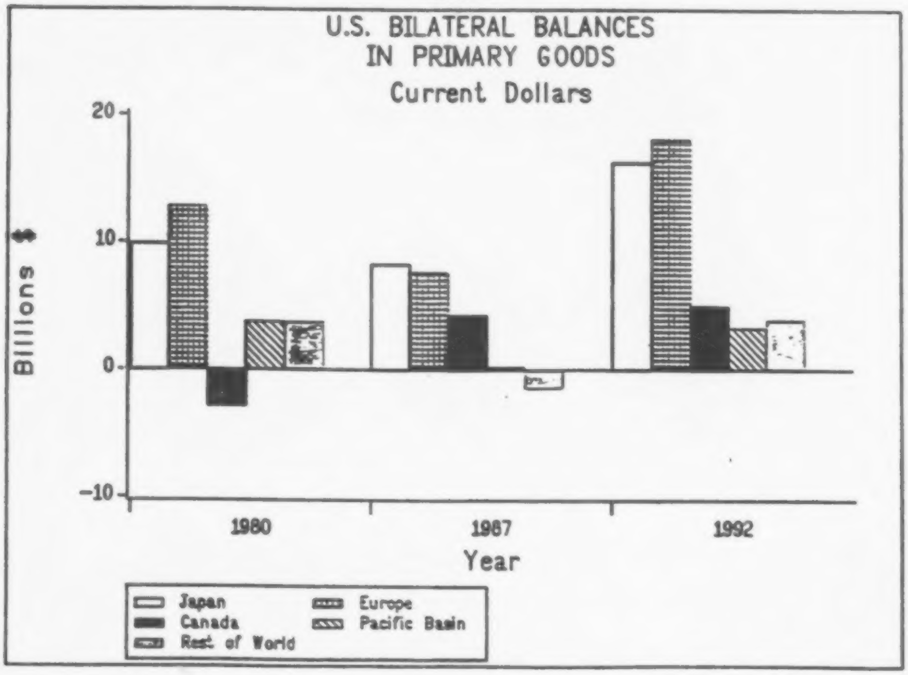


TABLE 1.1 WORLD FORECAST SUMMARY

	1985	1986	1987	1988	1989	1990	1991	1992
	REAL GDP (PERCENT CHANGE)							
WORLD	3.1	2.9	2.6	3.0	2.9	2.1	3.5	3.0
OECD	3.2	2.7	2.5	2.9	2.5	1.9	3.5	2.7
UNITED STATES	3.3	3.1	2.6	3.6	2.3	1.2	4.1	2.9
CANADA	4.3	3.3	3.1	3.1	3.0	-0.4	3.9	3.2
JAPAN	4.7	2.5	3.0	2.9	2.4	2.4	3.0	2.8
EUROPE	2.6	2.6	2.3	2.4	2.7	2.4	3.1	2.5
GERMANY	2.6	2.5	1.4	2.4	2.3	3.0	2.6	1.7
FRANCE	1.7	2.1	1.7	1.8	2.2	2.1	2.7	2.6
ITALY	2.3	2.7	2.7	3.0	3.1	1.5	3.4	2.2
UNITED KINGDOM	3.6	2.7	3.3	2.2	2.2	2.1	3.2	2.9
DEVELOPING COUNTRIES	2.4	2.4	2.2	3.5	3.9	2.6	3.9	4.2
AFRICA	1.5	-4.4	-1.5	0.6	3.0	1.6	2.4	3.0
LATIN AMERICA	3.8	4.0	1.4	2.9	3.1	2.1	3.2	3.3
PACIFIC BASIN	2.3	5.8	6.8	6.1	5.9	3.3	5.6	6.0
ARABIAN GULF	-2.9	0.8	-0.5	3.9	4.9	4.3	5.6	4.7
OTHER ASIA & MIDDLE EAST	4.2	2.1	3.9	4.2	4.0	2.8	3.8	4.6
CENTRALLY PLANNED ECONOMIES	3.3	4.1	3.0	3.0	3.1	2.7	3.0	3.0
	PRIVATE CONSUMPTION DEFLATORS (PERCENT CHANGE)							
OECD	4.8	2.9	3.6	4.5	4.7	4.6	4.0	5.1
UNITED STATES	3.4	2.2	4.1	4.5	5.0	4.7	3.4	3.4
CANADA	4.0	4.2	4.4	4.8	5.5	5.2	3.1	3.5
JAPAN	2.1	0.6	-0.3	3.3	3.7	3.5	3.4	3.1
EUROPE	6.4	3.5	3.8	4.5	4.4	4.5	4.5	4.8
FRANCE	5.7	2.5	3.2	3.1	3.4	3.8	3.8	3.9
GERMANY	2.1	-0.4	0.7	2.2	2.2	2.1	2.8	3.5
ITALY	9.5	6.1	4.4	4.7	4.7	4.8	5.2	5.4
UNITED KINGDOM	5.3	3.6	4.2	5.6	5.3	5.4	5.6	6.4
	UNEMPLOYMENT RATES (PERCENT OF LABOR FORCE)							
OECD	8.7	8.6	8.3	8.0	7.9	8.1	7.6	7.2
UNITED STATES	7.2	7.0	6.2	5.7	5.9	6.7	6.0	5.8
CANADA	10.4	9.6	9.3	9.0	8.4	8.8	8.3	7.8
JAPAN	2.6	2.8	3.1	3.5	3.6	3.5	3.3	3.2
EUROPE	11.3	11.2	11.0	10.6	10.2	9.9	9.4	8.9
GERMANY	9.3	9.0	8.8	8.4	8.1	7.6	7.1	6.6
FRANCE	10.2	10.5	10.9	10.8	10.9	11.2	11.5	11.6
UNITED KINGDOM	13.0	13.1	12.2	11.5	11.0	10.4	9.4	8.1
	SELECTED COMMODITY DOLLAR EXPORT PRICES (PERCENT CHANGE)							
WHEAT	-4.7	-9.8	-10.0	-1.5	5.3	5.5	7.7	7.7
OTHER CEREALS	-19.1	-6.6	-16.2	3.3	3.9	5.7	6.3	7.9
COFFEE, TEA, COCOA	-11.5	23.5	-20.6	6.0	5.0	4.5	5.0	5.0
SAUDIA ARABIA AVERAGE EXPORT PRICE OF CRUDE PETROLEUM ($/BARREL)	27.75	14.00	16.70	17.10	17.15	17.15	18.85	20.37
PERCENT CHANGE PER YEAR	-2.5	-49.5	19.3	2.4	0.3	0.0	9.9	8.1
	SHORT-TERM INTEREST RATES (PERCENT)							
LONDON INTERBANK RATE	8.4	6.9	7.1	8.7	9.5	9.0	7.6	7.7
UNITED STATES	8.0	6.4	6.8	8.0	9.3	8.5	7.1	7.2
JAPAN	6.5	4.8	3.2	4.0	4.1	5.0	5.2	5.2
GERMANY	5.2	4.6	3.9	4.4	4.9	4.7	4.7	5.0
FRANCE	9.9	7.7	8.2	8.9	8.9	8.2	7.7	7.5
UNITED KINGDOM	11.5	10.4	9.5	10.3	9.4	9.0	9.5	9.9
	EFFECTIVE EXCHANGE RATES (MERM WEIGHTS, PERCENT CHANGE)							
UNITED STATES	4.2	-18.2	-11.2	-6.6	-1.9	1.3	3.2	0.9
JAPAN	2.5	26.7	8.2	5.1	1.8	-1.0	-3.5	-1.5
GERMANY	0.1	10.8	7.0	4.8	2.8	0.0	-0.9	1.3
FRANCE	1.0	5.9	2.8	1.0	0.2	-0.1	0.1	1.4
UNITED KINGDOM	-0.4	-7.2	-0.4	3.7	0.4	-0.3	-2.7	-2.6
	WORLD TRADE (PERCENT CHANGE)							
VOLUMES(EXPORTS), TOTAL	2.6	5.2	4.0	4.3	4.1	2.7	4.6	3.9
PRIMARY COMMODITIES (NON-FUEL)	5.5	5.9	5.2	5.9	5.7	4.3	5.0	4.5
FUELS	-6.9	15.4	3.1	5.8	5.4	4.3	1.8	3.7
MANUFACTURED GOODS	4.2	2.7	3.9	3.4	3.3	1.8	5.2	3.7
PRICES (EXPORT DEFLATORS,DOLLARS), TOTAL	-1.4	4.2	10.5	8.1	4.4	2.1	2.3	4.1
PRIMARY COMMODITIES (NON-FUEL)	-9.2	4.0	5.5	4.3	1.6	1.0	2.1	3.8
FUELS	1.5	-37.9	10.9	3.8	1.6	0.8	7.5	7.3
MANUFACTURED GOODS	0.3	16.7	11.6	10.0	5.7	2.9	1.4	3.7
	CURRENT ACCOUNT BALANCES (US$ BILLION)							
UNITED STATES	-116.4	-141.4	-149.7	-150.1	-160.7	-133.8	-133.7	-127.3
JAPAN	49.2	85.7	85.3	78.9	85.9	67.4	53.3	44.7
EUROPE	25.5	56.9	32.2	26.6	33.2	21.6	23.1	26.3
DEVELOPING COUNTRIES	-9.9	-33.4	-8.3	0.8	3.1	15.3	20.5	33.2
CENTRALLY PLANNED ECONOMIES	-8.8	-8.7	-0.6	0.3	1.6	1.4	2.0	3.4

TABLE 2.2 GROWTH, UNEMPLOYMENT AND INFLATION

	FIRST OIL SHOCK 1974-75	RECOVERY 1976-79	SECOND OIL SHOCK 1980-82	RECOVERY 1983-86	CURRENT FORECAST 1987	CURRENT FORECAST 1988-92
REAL GDP (AVERAGE ANNUAL GROWTH RATES, PERCENT)						
WORLD	1.5	4.3	1.1	3.0	2.6	2.9
OECD	0.2	3.9	0.8	3.1	2.5	2.7
UNITED STATES	-0.9	4.2	-0.2	4.0	2.6	2.8
CANADA	2.5	3.9	0.9	3.9	3.1	2.6
JAPAN	0.6	5.0	3.7	3.9	3.0	2.7
EUROPE	0.6	3.3	0.6	2.2	2.3	2.6
EEC	0.4	3.4	0.5	2.1	2.2	2.6
GERMANY	-0.7	3.8	0.3	2.3	1.4	2.4
FRANCE	1.7	3.8	1.1	1.5	1.7	2.3
ITALY	0.2	3.8	1.2	1.9	2.7	2.6
UNITED KINGDOM	-0.9	2.7	-0.8	3.0	3.3	2.5
OTHER EUROPE	2.3	2.5	1.8	3.1	2.6	3.0
AUSTRALIA	1.9	3.3	2.9	2.6	2.6	2.4
DEVELOPING COUNTRIES	4.8	6.3	1.4	1.8	2.2	3.6
AFRICA	2.4	3.8	0.4	-1.5	-1.5	1.9
LATIN AMERICA	4.3	7.3	1.6	1.8	1.4	2.9
PACIFIC BASIN	5.5	9.0	6.5	5.2	6.8	5.4
ARABIAN GULF	6.3	4.8	-5.6	-1.4	-0.5	4.7
OTHER ASIA & MIDDLE EAST	6.5	3.5	4.1	4.0	3.9	3.9
CENTRALLY PLANNED ECONOMIES	3.6	3.6	2.1	3.7	3.0	3.0
UNEMPLOYMENT RATES (PERCENT OF LABOR FORCE,ANNUAL AVERAGE)						
OECD	4.9	5.7	7.5	9.1	8.3	7.8
UNITED STATES	7.1	6.7	8.2	7.8	6.2	6.0
CANADA	6.1	7.7	8.6	10.7	9.3	8.5
JAPAN	1.6	2.1	2.2	2.7	3.1	3.4
EUROPE	4.3	5.9	8.4	11.6	11.0	9.8
EEC	3.6	5.4	8.0	11.5	11.4	10.5
GERMANY	2.6	3.5	4.5	8.3	8.8	7.6
FRANCE	3.0	4.9	7.4	9.8	10.9	11.2
ITALY	5.6	7.1	8.3	10.4	10.1	8.9
UNITED KINGDOM	3.6	5.6	9.2	12.9	12.2	10.1
OTHER EUROPE	7.5	7.9	9.9	12.2	9.4	6.8
AUSTRALIA	3.7	5.7	6.3	8.8	8.2	8.2
PRIVATE CONSUMPTION DEFLATORS (AVERAGE ANNUAL GROWTH RATES, PERCENT)						
OECD	12.3	1.7	9.8	4.7	3.6	4.4
UNITED STATES	9.3	7.2	8.6	3.4	4.1	4.2
CANADA	10.9	8.3	10.8	4.7	4.4	4.4
JAPAN	16.6	5.9	4.7	1.7	-0.3	3.4
EUROPE	13.4	10.6	12.2	6.5	3.8	4.5
EEC	13.4	10.1	11.1	5.7	3.1	4.0
GERMANY	6.6	3.6	5.6	1.8	0.7	2.6
FRANCE	12.3	9.5	12.4	6.3	3.2	3.6
ITALY	19.2	16.0	18.8	10.4	4.4	5.0
UNITED KINGDOM	20.3	13.3	12.0	4.7	4.2	5.7
OTHER EUROPE	13.4	13.5	19.6	11.8	8.7	7.5
AUSTRALIA	16.2	10.7	10.0	8.3	7.9	7.4

TABLE 1
WEFA Bilateral Trade Outlook

UNITED STATES
TOTALS

U.S. MERCHANDISE TRADE BALANCES

Total and Bilateral in Current and 1980 Dollars
Sourced from: World Model Forecast 10/87

Mn Current $	1984	1985	1986	1987	1988	1989	1990	1991	1992
TOTAL									
Exports	212,038	206,902	209,133	239,620	279,587	309,492	342,200	381,160	428,364
Imports	310,010	324,540	364,322	399,680	437,485	468,418	476,296	512,217	555,984
Balance	-97,972	-117,638	-155,188	-160,060	-157,898	-158,926	-134,096	-131,058	-127,620
JAPAN									
U.S. Exports to:	25,202	23,663	26,421	30,469	37,674	41,929	47,497	53,405	59,980
U.S. Imports from:	57,429	65,671	78,517	79,685	88,424	93,233	92,819	95,495	99,935
Balance	-32,227	-42,008	-52,096	-49,216	-50,749	-51,304	-45,322	-42,090	-39,955
EUROPE									
U.S. Exports to:	52,315	51,437	55,819	67,245	80,063	89,245	100,682	111,820	126,558
U.S. Imports from:	68,034	78,499	92,937	99,165	107,472	115,559	118,460	127,151	137,778
Balance	-15,720	-27,061	-37,118	-31,920	-27,410	-26,314	-17,778	-15,331	-11,220
CANADA									
U.S. Exports to:	48,494	50,173	52,552	56,200	62,232	67,455	71,159	77,624	83,748
U.S. Imports from:	61,535	63,222	63,113	67,783	73,333	78,464	77,394	84,530	91,733
Balance	-13,041	-13,049	-10,560	-11,584	-11,101	-11,009	-6,235	-6,906	-7,985
PACIFIC BASIN									
U.S. Exports to:	24,313	24,422	24,351	29,305	34,960	39,129	43,929	50,458	58,632
U.S. Imports from:	43,417	49,908	56,576	68,114	72,678	77,752	79,147	85,817	92,148
Balance	-19,104	-25,487	-32,225	-38,809	-37,718	-38,623	-35,218	-35,360	-33,516
ALL OTHER									
U.S. Exports to:	61,715	57,207	49,991	56,401	64,658	71,736	78,932	87,854	99,446
U.S. Imports from:	79,595	67,240	73,179	84,932	95,578	103,411	108,476	119,225	134,390
Balance	-17,880	-10,033	-23,188	-28,532	-30,919	-31,675	-29,543	-31,371	-34,944
Mn 1980 $									
TOTAL									
Exports	195,224	192,314	198,808	232,472	261,588	279,760	299,711	320,836	345,307
Imports	343,420	366,350	387,334	388,369	391,395	398,864	393,582	410,927	421,984
Balance	-148,196	-174,036	-188,526	-155,898	-129,807	-119,104	-93,872	-90,092	-76,677
JAPAN									
U.S. Exports to:	24,833	24,016	26,949	31,951	37,195	39,602	43,142	46,443	50,157
U.S. Imports from:	60,316	70,454	68,365	63,485	60,798	59,644	56,699	57,357	57,958
Balance	-35,483	-46,438	-41,416	-31,534	-23,603	-20,042	-13,557	-10,914	-7,801
EUROPE									
U.S. Exports to:	49,803	49,573	53,688	65,310	74,295	79,981	87,516	94,117	102,102
U.S. Imports from:	88,512	101,660	102,258	96,693	93,952	94,154	91,871	95,822	97,590
Balance	-38,709	-52,087	-48,570	-31,384	-19,657	-14,173	-4,355	-1,705	4,511
CANADA									
U.S. Exports to:	42,190	43,352	45,985	49,161	52,398	54,344	55,173	58,009	59,759
U.S. Imports from:	61,505	64,339	66,481	67,529	69,332	71,620	69,570	72,944	74,997
Balance	-19,315	-20,987	-20,496	-18,368	-16,934	-17,276	-14,396	-14,935	-15,238
PACIFIC BASIN									
U.S. Exports to:	22,110	22,671	23,575	29,260	34,342	37,465	40,370	43,662	48,154
U.S. Imports from:	49,772	56,666	57,908	64,250	65,108	66,978	65,067	67,353	68,673
Balance	-27,662	-33,995	-34,333	-34,989	-30,766	-29,512	-24,698	-23,691	-20,518
ALL OTHER									
U.S. Exports to:	56,287	52,701	48,612	56,791	63,358	68,367	73,510	78,605	85,135
U.S. Imports from:	83,315	73,231	92,323	96,413	102,205	106,467	110,376	117,451	122,767
Balance	-27,027	-20,530	-43,711	-39,622	-38,847	-38,100	-36,866	-38,846	-37,632

TABLE 2
WEFA Bilateral Trade Outlook

UNITED STATES
PRIMARY

U.S. PRIMARY COMMODITIES TRADE BALANCES

Total and Bilateral in Current and 1980 Dollars
Sourced from: World Model Forecast 10/87

	1984	1985	1986	1987	1988	1989	1990	1991	1992
Mn Current $									
TOTAL									
Exports	49,480	40,603	41,304	46,797	54,853	60,854	67,479	75,133	84,509
Imports	31,857	32,575	34,294	36,412	39,365	41,865	41,978	44,884	47,931
Balance	17,623	8,028	7,010	10,386	15,487	18,989	25,500	30,248	36,578
JAPAN									
U.S. Exports to:	9,145	7,698	7,872	8,651	10,448	11,700	13,083	14,869	16,778
U.S. Imports from:	326	325	378	388	417	443	443	474	507
Balance	8,819	7,372	7,495	8,263	10,030	11,257	12,639	14,395	16,271
EUROPE									
U.S. Exports to:	14,016	11,487	12,070	14,451	16,970	18,950	21,297	23,723	26,647
U.S. Imports from:	4,886	5,573	6,354	6,815	7,312	7,704	7,647	8,117	8,572
Balance	9,129	5,913	5,715	7,636	9,658	11,246	13,650	15,606	18,075
CANADA									
U.S. Exports to:	4,210	3,540	3,704	3,666	4,039	4,290	4,460	4,789	5,146
U.S. Imports from:	8,357	7,985	7,906	8,037	8,590	9,081	9,032	9,624	10,245
Balance	-4,146	-4,445	-4,202	-4,371	-4,551	-4,790	-4,572	-4,835	-5,099
PACIFIC BASIN									
U.S. Exports to:	6,617	5,813	5,368	6,018	7,178	8,070	8,818	9,862	11,287
U.S. Imports from:	4,425	4,033	4,604	5,788	6,334	6,791	6,879	7,407	7,977
Balance	2,191	1,780	764	230	844	1,279	1,939	2,455	3,310
ALL OTHER									
U.S. Exports to:	15,492	12,066	12,288	14,012	16,217	17,843	19,821	21,891	24,652
U.S. Imports from:	13,862	14,658	15,051	15,385	16,711	17,845	17,977	19,262	20,631
Balance	1,629	-2,592	-2,763	-1,373	-494	-2	1,844	2,628	4,021
Mn 1980 $									
TOTAL									
Exports	60,259	56,192	55,401	71,312	81,842	90,025	98,893	106,040	115,884
Imports	40,065	44,787	44,709	45,147	46,698	48,684	48,129	50,184	51,040
Balance	20,194	11,405	10,692	26,165	35,144	41,341	50,764	55,856	64,844
JAPAN									
U.S. Exports to:	11,134	10,652	10,616	13,271	15,661	16,978	18,674	20,216	22,088
U.S. Imports from:	427	469	510	500	509	532	524	543	557
Balance	10,707	10,183	10,106	12,770	15,152	16,447	18,151	19,673	21,531
EUROPE									
U.S. Exports to:	17,068	15,892	16,016	21,688	24,753	27,434	30,553	33,072	36,313
U.S. Imports from:	6,707	8,311	8,575	8,546	8,790	9,248	9,208	9,601	9,728
Balance	10,362	7,581	7,441	13,142	15,963	18,186	21,346	23,470	26,585
CANADA									
U.S. Exports to:	5,128	4,899	5,094	5,647	6,126	6,505	6,720	6,936	7,226
U.S. Imports from:	10,124	10,472	10,444	9,842	10,127	10,471	10,278	10,586	10,787
Balance	-4,996	-5,573	-5,350	-4,196	-4,001	-3,965	-3,559	-3,650	-3,562
PACIFIC BASIN									
U.S. Exports to:	8,062	8,051	7,248	9,255	10,881	12,224	13,266	14,253	15,801
U.S. Imports from:	5,475	5,554	6,056	7,516	8,138	8,922	8,992	9,643	10,203
Balance	2,586	2,496	1,192	1,740	2,743	3,302	4,274	4,610	5,598
ALL OTHER									
U.S. Exports to:	18,867	16,698	16,427	21,451	24,422	26,883	29,679	31,563	34,456
U.S. Imports from:	17,332	19,981	19,125	18,743	19,135	19,511	19,127	19,811	19,765
Balance	1,535	-3,283	-2,697	2,708	5,287	7,371	10,552	11,753	14,691

TABLE 3
WEFA Bilateral Trade Outlook

UNITED STATES
MANUFACTURED

U.S. MANUFACTURED COMMODITIES TRADE BALANCES

Total and Bilateral in Current and 1980 Dollars
Sourced from: World Model Forecast 10/87

Mn Current $	1984	1985	1986	1987	1988	1989	1990	1991	1992
TOTAL									
Exports	153,247	156,329	159,719	183,668	215,161	238,686	264,454	295,400	332,132
Imports	222,287	255,570	293,581	312,633	337,194	358,113	358,453	383,101	408,277
Balance	-69,040	-99,241	-133,862	-128,966	-122,033	-119,427	-94,000	-87,701	-76,145
JAPAN									
U.S. Exports to:	13,722	13,509	16,415	19,583	24,857	27,800	31,920	36,090	40,573
U.S. Imports from:	57,093	65,342	78,129	79,284	87,990	92,771	92,355	94,996	99,398
Balance	-43,372	-51,833	-61,714	-59,701	-63,133	-64,971	-60,435	-58,906	-58,825
EUROPE									
U.S. Exports to:	35,915	37,224	41,798	50,548	60,664	67,788	76,775	85,503	97,079
U.S. Imports from:	55,345	67,777	81,259	85,507	92,102	98,809	100,723	108,935	118,048
Balance	-19,430	-30,553	-39,461	-34,960	-31,437	-31,021	-23,949	-23,431	-20,968
CANADA									
U.S. Exports to:	43,042	45,332	47,330	50,730	56,518	61,415	64,932	70,761	76,249
U.S. Imports from:	43,596	45,970	48,147	50,710	53,678	56,703	54,022	58,512	61,696
Balance	-554	-638	-817	20	2,840	4,712	10,910	12,249	14,553
PACIFIC BASIN									
U.S. Exports to:	16,991	17,803	18,365	22,608	27,026	30,236	34,260	39,728	46,382
U.S. Imports from:	37,173	44,870	51,039	60,789	64,445	68,859	69,914	75,720	80,920
Balance	-20,181	-27,067	-32,674	-38,181	-37,419	-38,623	-35,654	-35,992	-34,537
ALL OTHER									
U.S. Exports to:	43,577	42,461	35,810	40,199	46,096	51,448	56,567	63,318	71,849
U.S. Imports from:	29,081	31,611	35,007	36,343	38,979	40,971	41,440	44,939	48,217
Balance	14,497	10,850	804	3,856	7,117	10,476	15,127	18,379	23,632
Mn 1980 $									
TOTAL									
Exports	126,658	127,783	133,565	151,074	169,682	179,517	190,528	204,423	218,986
Imports	245,994	284,210	281,691	272,744	265,994	265,664	253,562	261,525	264,213
Balance	-119,336	-156,427	-148,125	-121,671	-96,312	-86,147	-63,034	-57,102	-45,227
JAPAN									
U.S. Exports to:	11,584	11,265	13,695	15,073	18,986	20,066	21,901	23,792	25,673
U.S. Imports from:	59,880	69,982	67,842	6[illegible] 969	60,272	59,096	56,157	56,792	57,377
Balance	-48,296	-58,717	-54,147	-46,996	-41,287	-39,029	-34,256	-32,999	-31,704
EUROPE									
U.S. Exports to:	30,521	31,275	35,054	41,001	46,776	49,729	54,074	58,255	63,008
U.S. Imports from:	74,148	88,319	85,237	79,046	76,215	76,153	73,804	77,229	78,972
Balance	-43,627	-57,044	-50,183	-38,045	-29,439	-26,424	-19,729	-18,974	-15,964
CANADA									
U.S. Exports to:	35,955	37,365	39,011	41,519	44,498	46,041	46,685	49,021	50,424
U.S. Imports from:	42,535	45,664	46,789	46,551	46,375	46,952	43,653	45,303	44,971
Balance	-6,580	-8,300	-7,778	-5,032	-1,877	-911	3,032	3,718	5,452
PACIFIC BASIN									
U.S. Exports to:	13,466	14,015	15,756	19,405	22,829	24,[illegible]82	26,453	28,767	31,698
U.S. Imports from:	42,466	50,094	50,364	54,842	54,750	55,711	53,488	54,765	55,305
Balance	-29,000	-36,079	-34,607	-35,437	-31,921	-31,129	-27,035	-25,999	-23,607
ALL OTHER									
U.S. Exports to:	35,132	33,864	30,049	33,076	36,592	39,098	41,416	44,587	48,183
U.S. Imports from:	26,964	30,151	31,460	29,337	28,380	27,[illegible]51	26,460	27,436	27,587
Balance	8,167	3,713	-1,410	3,739	8,212	11,[illegible]47	14,955	17,151	20,595

TABLE 4
WEFA Bilateral Trade Outlook

UNITED STATES
ENERGY

U.S. ENERGY COMMODITIES TRADE BALANCES

Total and Bilateral in Current and 1980 Dollars
Sourced from: World Model Forecast 10/87

Mn Current $	1984	1985	1986	1987	1988	1989	1990	1991	1992
TOTAL									
Exports	9,312	9,970	8,111	9,155	9,574	9,952	10,267	10,627	11,722
Imports	55,866	36,396	36,447	50,635	60,926	68,440	75,864	84,232	99,775
Balance	-46,554	-26,425	-28,336	-41,480	-51,353	-58,488	-65,597	-73,605	-88,052
JAPAN									
U.S. Exports to:	2,335	2,457	2,134	2,236	2,370	2,428	2,495	2,445	2,630
U.S. Imports from:	9	4	10	13	16	19	21	24	30
Balance	2,326	2,453	2,124	2,222	2,353	2,410	2,473	2,421	2,600
EUROPE									
U.S. Exports to:	2,384	2,726	1,951	2,247	2,428	2,507	2,611	2,594	2,832
U.S. Imports from:	7,803	5,148	5,324	6,843	8,058	9,046	10,090	10,099	11,159
Balance	-5,419	-2,422	-3,373	-4,596	-5,630	-6,539	-7,479	-7,505	-8,327
CANADA									
U.S. Exports to:	1,242	1,301	1,518	1,803	1,675	1,750	1,767	2,074	2,354
U.S. Imports from:	9,583	9,267	7,059	9,037	11,065	12,680	14,340	16,394	19,792
Balance	-8,341	-7,966	-5,541	-7,233	-9,390	-10,930	-12,573	-14,319	-17,439
PACIFIC BASIN									
U.S. Exports to:	705	806	617	680	756	823	851	868	962
U.S. Imports from:	1,819	1,005	933	1,537	1,900	2,101	2,354	2,691	3,251
Balance	-1,114	-199	-316	-857	-1,144	-1,279	-1,503	-1,822	-2,289
ALL OTHER									
U.S. Exports to:	2,646	2,680	1,892	2,190	2,345	2,445	2,544	2,645	2,945
U.S. Imports from:	36,652	20,971	23,121	33,205	39,887	44,594	49,059	55,024	65,543
Balance	-34,006	-18,292	-21,229	-31,015	-37,542	-42,150	-46,515	-52,379	-62,598
Mn 1980 $									
TOTAL									
Exports	8,307	8,339	9,841	10,086	10,064	10,218	10,289	10,373	10,438
Imports	57,360	37,353	60,934	70,478	78,703	84,516	91,892	99,218	106,732
Balance	-49,054	-29,014	-51,093	-60,392	-68,639	-74,298	-81,602	-88,845	-96,294
JAPAN									
U.S. Exports to:	2,115	2,099	2,638	2,607	2,548	2,557	2,567	2,435	2,397
U.S. Imports from:	8	3	13	15	16	17	19	22	24
Balance	2,106	2,096	2,625	2,592	2,532	2,540	2,549	2,413	2,372
EUROPE									
U.S. Exports to:	2,214	2,406	2,618	2,621	2,766	2,818	2,888	2,790	2,780
U.S. Imports from:	7,657	5,030	8,446	9,102	8,947	8,753	8,859	8,992	8,890
Balance	-5,443	-2,624	-5,828	-6,481	-6,181	-5,935	-5,971	-6,202	-6,110
CANADA									
U.S. Exports to:	1,107	1,089	1,880	1,995	1,774	1,797	1,769	2,052	2,110
U.S. Imports from:	8,846	8,203	9,248	11,135	12,830	14,197	15,638	17,055	19,239
Balance	-7,739	-7,114	-7,368	-9,141	-11,056	-12,400	-13,870	-15,003	-17,129
PACIFIC BASIN									
U.S. Exports to:	582	605	570	600	632	660	651	642	655
U.S. Imports from:	1,830	1,018	1,488	1,892	2,220	2,345	2,587	2,944	3,165
Balance	-1,248	-413	-918	-1,293	-1,588	-1,685	-1,937	-2,302	-2,510
ALL OTHER									
U.S. Exports to:	2,289	2,139	2,135	2,263	2,344	2,386	2,415	2,455	2,496
U.S. Imports from:	39,019	23,098	41,738	48,333	54,690	59,205	64,788	70,204	75,414
Balance	-36,730	-20,960	-39,603	-46,070	-52,346	-56,818	-62,374	-67,750	-72,919

Senator **Sarbanes**. Thank you very much, Mr. Bird. We obviously are holding the questions until we hear from the entire panel. Mr. Roach, please proceed.

STATEMENT OF STEPHEN S. ROACH, PRINCIPAL AND SENIOR ECONOMIST, MORGAN STANLEY & CO., INC.

Mr. **Roach**. Thank you, Mr. Chairman.

My name is Stephen Roach, I am a principal and senior economist with Morgan Stanley, a New York based investment banking firm. I have a prepared statement that's been submitted for the record.

In my opinion, the past 2½ weeks have offered a very clear illustration of the serious impacts that America's foreign trade dilemma can have on the marketplace.

I would just like to focus on two aspects of recent and perspective trends in U.S. foreign trade.

One, the broad macroeconomic factors that, in my opinion, still condition our unacceptably large trade gap; and two, the specific problems in the capital goods sector with an emphasis on the high technology items that are produced by what many presume to be our so-called leading edge industries.

There's a separate handout in front of you entitled "Materials to Accompany Testimony." It has some tables and charts that I'd like to draw your attention to if I may. These tables and charts also appear in my prepared statement.

Let me start with table 1 which provides a fair amount of detail on the merchandise trade portion of U.S. foreign trade activity. I've circled a few key numbers that I think are worth noting.

On the export side, as you can see, the improvement has been very impressive. The total volume of American goods sold abroad expanded by 16.2 percent over the past year. That's double the gain over the prior fourth quarter interval. Moreover, we've had broadly based increases, with especially impressive performance in the volume of agricultural and consumer goods commodities. There have also been solid increases in exports of industrial materials and capital goods.

On the import side, I'm sorry to say, the news remains very disconcerting. Merchandise import volumes have expanded by almost 3 percent over the most recent four quarters, with very sharp increases in capital goods and petroleum products. Moreover, import volumes have failed to recede for consumer goods and there have been only fractional declines in unit sales of foreign-made cars.

Overall, despite the fact that these trends have been sufficient to initiate a turn in what we call the "real" or volume-based trade gap, they are not sufficient, in my opinion, to produce a prompt resolution of the problem.

The reason is, as of the third quarter of 1987, merchandise import volumes remained 57 percent larger than the volume of merchandise exports. If recent import trends continue, and exports settle down to a more normal 8 percent annualized gain, it would take about another 6 to 9 years to eliminate the merchandise trade gap.

The essence of our trade dilemma, is that we have a very serious import problem, despite almost 3 years of a massive currency correction. The fact that the volume of merchandise imports expanded at all over the past year—after the dollar had fallen by more than 40 percent from its early 1985 highs—is perhaps the most alarming trend of all.

Let me cite two reasons that I think are critical in explaining our continued high levels of import demand. One has to do with import pricing and the second has to do with the level of domestic demand in the U.S. economy.

Figure 1 in this handout illustrates the point on pricing. What I show in the upper panel of this figure is a comparison between import prices and prices of a comparable market basket of American made goods—excluding food and energy.

The simple fact of the matter is, that for American businesses and consumers, imports still look cheap. To be sure, import prices have been rising about 8 percent a year now for the past year and a half, which is more than twice the domestic inflation rate. But that improvement in relative prices follows nearly 4 years when declining import prices were steadily undercutting the prices of domestically made products. By mid-1985, the differential between domestic and import price levels had widened to almost 20 percentage points by our estimation. Over the past year and a half, barely one-quarter of that gap has been closed.

The lower portion of figure 1 tells us how this was accomplished. The answer is profit margins. During the strong dollar era of 1980 to 1985, foreign producers built up an enormous reservoir of profitability. That's the shaded area in the lower panel of figure 1. As foreign currencies appreciated against the dollar over the past 2½ years, a drawdown of profits was used to finance the relatively limited increases in import prices.

This strategy of compressing profit margins was very effective in enabling foreign producers to defend their market shares in the face of a weaker dollar. I should add, however, that foreign producers, by our estimates, are now at the critical break-even point in their pricing of American imports. Profit margins have disappeared according to our estimates.

Consequently, any further currency depreciation could well prompt a faster realignment in relative prices in favor of goods produced in the United States. It's a key point. It simply means that from here on out a further drop in the dollar could give us a bigger bank on the trade gap.

A second very important point behind our import problem is the enormous divergence in demand between the United States and the rest of the world. This is illustrated in figure 2 of my prepared statement.

Over the past 4½ years, real domestic demand has expanded 27 percent in the United States in real terms. That's almost twice the growth experienced by our trading partners. What that means is that import volumes would have increased in line with excessive demand growth even if the import content of our economy had remained stable.

What about exports? Well, that certainly is a segment of our trade situation that has been doing very well and I do not want to minimize the fact that we are encouraged by those developments. But there's a problem here, as well, and the markets over the last few months caught on to that very quickly.

The problem with an export boom as being used as a solution to our trade gap is that such a boom would immediately put many industries against severe capacity constraints and potentially trigger a new round of accelerating inflation. I illustrate some hypothetical scenarios in figure 3 of the prepared statement.

This figure looks at the capacity utilization rate for U.S. manufacturing industries. The factory sector operating rate is right now about 81 percent—its highest level since 1980. Now we had a phenomenal growth of industrial production in the third quarter of this year—8.5 percent at an annual rate, with a large part of it caused by the export boom. If industrial production kept growing at a pace comparable to that experienced in the third quarter, the operating rate would pierce 90 percent by mid-1989. That's our so-called fast growth scenario.

Even a moderate growth scenario, only 5 percent gains in production, which are well below the export-induced surges of the past several months, would take the capacity utilization rate above the 85 percent barrier by early 1989.

So another important conclusion here is that inflation risks would be very high if the U.S. economy attempted to export its way out of our trade gap.

Let me turn to what I think are some key trends in major product categories of foreign trade—an analysis that addresses the questions raised earlier by Congressman McMillan.

Table 2 decomposes the erosion in merchandise trade that has occurred over the course of the present decade into what the Government refers to as major end-use product groupings. The number I circled bears on capital goods. As you can see, capital goods has been the biggest contributor to our $168 billion deterioration in the "real" merchandise trade gap that's occurred since mid-1980.

Over this 7-year timeframe, a slippage in the capital goods trade balance has accounted for 32 percent or close to one-third of the cumulative erosion in total merchandise trade. That far outdistances the contribution made by any of the other major product categories that we have identified.

As figure 4 illustrates, a steady slippage in capital goods trade has occurred over the entire course of the present decade. It was especially dramatic in the 1981 to 1983 interval and then in 1984 to 1985 we entered the final throb of our surplus in capital trade. The United States finally hit zero on our capital goods trade balance in the middle of 1986 and we've bounced around near that level ever since.

It's very important, however, to look behind this broad trend in capital goods trade, and here's where the plot thickens.

Figure 5 decomposes capital goods trade flows into what we have referred to as "high tech" and "low tech" categories. We define high-tech capital goods to include electrical machinery and electronic components, communications equipment, computers, other office equipment, and scientific instruments and measuring devices. Low tech is the residual of capital goods trade and basically includes industrial machinery, construction industry machinery and the like.

As this figure clearly indicates, the trade prognosis looks especially most worrisome in the high-technology area. The high-tech capital goods trade balance slipped into deficit in late 1983 and since then this shortfall has widened appreciably further. From early 1985 to the second quarter of 1987, the slippage of high-tech capital trade, by our accounts, amounted to 54 percent of the cumulative erosion of America's overall position in capital goods trade. We still have a surplus in low-tech capital goods trade, but even that's been dwindling over the past several years.

Figure 6 illustrates that the pressures on U.S. high-tech producers are concentrated solely on the import side. This shows up clearly in an examination of relative import penetration ratios. Important penetration ratios measure the share of our domestic markets that can be accounted for by foreign made goods. A key result of our analysis is that the import penetration ratio in the high-tech capital goods markets moved above 21 percent by the middle of 1987. That's over 5 percentage points higher than the foreign market share for total U.S. merchandise. What that means is that $1 out of every $5 spent in the United States on high-tech capital goods is accounted for by foreign-produced goods.

By contrast, on the export side, there is reason for encouragement. As figure 7 indicates, exports of high-tech capital goods have clearly outperformed U.S. exports of other merchandise. Unfortunately, this trend really hasn't been enough to make a difference. Indeed, today's $10 billion deficit on high-tech capital goods trade is hardly suggestive of a leading edge sector of the American economy that remains relatively invincible to the onslaught of foreign competition.

I would conclude, unfortunately, that high-technology capital goods have not been a natural offset to the widening trade deficits in other segments of the U.S. economy.

Is there a way out? While the answer is probably, yes, there is certainly no avenue that offers instantaneous gratification.

Our problem remains one of excessive import demand. And, as I've indicated, American consumers and businessmen appear to have developed an insatiable appetite for goods made abroad. I do feel, however, that excessive import growth can eventually be arrested by a combination of a slower pace of domestic demand growth and further downward adjustment of the dollar on the foreign exchange markets.

I would urge you to consider the possibility that, for the time being at least, both of these trends are presently underway. There is a risk, however, and it's a very real one. If the economy goes through a temporary slowing in light of the events of the last few weeks, the risk is that the relief on the import side could turn out to be nothing more than a brief respite. If a slowing of demand next year is followed by a prompt return to trend rates of increase, then the U.S. economy could find itself right back on the path to overconsumption—the very same path, I might add, that gave us this import problem to start with.

In this light, I think the most effective way to guard against excessive demand growth is by a multiyear program of responsible reductions in our Federal budget deficit. The imperatives of such actions has really never been greater.

On the export side, we are doing just fine and the evidence suggests that we are also competing quite well in high-technology markets. On the other hand, it seems highly risky for us to browbeat our trading partners into faster growth in their own economies. I've tried to demonstrate that U.S. export demand has been growing about as fast as it can without rekindling inflationary pressures.

Finally, I would be derelict in my responsibility if I didn't note that any efforts to stifle market responses by protectionist measures would quickly be self-defeating. I think our import problem can be remedied over time by the combination of demand and currency adjustments, and the export recovery could be dealt a mortal blow by any retaliatory responses in U.S. trade policy.

If industry is to regain its competitive edge, it cannot be shielded from the challenges of the marketplace. I strongly feel that in the long run America must earn her share in global markets by being an efficient producer of high quality goods. The test of our competitive resolve is at hand and, unfortunately, there is no easy way out.

Thank you for your time.

[The prepared statement of Mr. Roach follows:]

PREPARED STATEMENT OF STEPHEN S. ROACH

America's Persistent Trade Gap

Mr. Chairman and members of the Committee, the lessons of October 19th bear directly on America's foreign trade dilemma. Over the past three months, market sentiment was jarred repeatedly by Government reports of surprisingly large shortfalls in merchandise trade. Since a weaker currency is a perfectly natural response to such an unacceptably wide trade gap, U.S. policy makers were in a bind. In essence, the economy was forced to pay a steep price to keep the dollar's exchange rate within the bands specified by the so-called Louvre accord. That price showed up in the form of a sharp upward movement in market interest rates over the first nine and one-half months of 1987. Unfortunately, by mid-October it became increasingly apparent that rising interest rates were on a collision course with the optimistic earnings expectations embedded in the lofty value of stock prices. The rest is history.

A particularly bitter pill to swallow is the growing fear in many quarters that the United States could be faced with seemingly chronic merchandise trade deficits well into the 1990's. While currency and demand disparities between America and her major trading partners appear to account for a significant portion of the present trade shortfall, there are also mounting concerns that this nation has lost its competitive edge. In the long run, an uncompetitive economy simply cannot maintain its share in world trade unless it is prepared to offer ever-larger price concessions in the form of a steadily depreciating currency. In the present environment, just the thought of such a possibility does little to calm the sentiments of a badly battered marketplace.

The Committee has asked me to assess recent and prospective trends in U.S. foreign trade, with an emphasis on activity in the capital goods sector. Such focus is well-directed, as it is my opinion that America's competitive struggle could well be won or lost in the arena of capital goods. The simple reason is that such items presently account for the dominant portion of both exports as well as imports. Moreover, capital goods are widely perceived to be the one group of American-made products that remains on the leading edge of technology -- presumed by many to be relatively immune to the pressures of foreign competition. Unfortunately, the evidence is not exactly supportive of this claim. A wider trade gap has not spared capital goods and there are some disquieting signs that the problems are most acute in the high technology area.

Such findings are worrisome, as they imply that market shares of all U.S. industries remain at risk. Consequently, there is a heightened urgency to give foreign trade considerations greater weight in the present debate on U.S. macroeconomic policy. Otherwise, the specter of wide trade deficits could haunt American industry for years to come.

Slow Motion

Market reaction aside, the U.S. has, in fact, begun to turn the corner on foreign trade. In volume, or inflation-adjusted terms, the deficit on net exports -- as it measured in the GNP accounts -- hit a high of $161.6-billion in 1986-QIII, and has since fallen to $137.9-billion in 1987-QIII. Over that four quarter time span, real GNP has increased by 3.0%, and the narrowing of the trade gap has accounted for 0.7 percentage points -- or almost 25% -- of the rise. On the surface, such progress certainly seems encouraging.

Table 1 provides detail on recent trends in the merchandise portion of U.S. foreign trade activity. On the export side, the improvement has been most impressive. The total volume of American goods sold abroad has expanded by 16.2% over the past year -- double the gain over the prior four-quarter interval. While increases have been broadly based, growth was especially rapid in the agriculture and consumer goods categories. Moreover, the volume of foreign sales of industrial materials and capital goods -- items that account for over 60% of total merchandise exports -- rose an impressive 13% over the past year.

However, on the import side, the news remains most disconcerting. Merchandise import volumes have expanded by almost 3% over the most recent four quarters, with sharp increases in capital goods and petroleum products. Moreover, import volumes have failed to recede

Table 1

Behind the Turnaround in Foreign Trade
(Four-Quarter Changes Over Designated Intervals)

	1985-QIII to 1986-QIII			1986-QIII to 1987-QIII			Trade Composition	
	Current Dollars	Price	Volume	Current Dollars	Price	Volume	1985-QIII	1987-QIII
Merchandise Exports	3.5%	-2.7%	8.1%	17.6%	2.7%	16.2%	100.0%	100.0%
Foods, Feeds, and Beverages	1.8	-10.6	13.8	28.6	-4.6	34.8	10.1	12.4
Industrial Materials	0.3	-4.0	4.5	17.7	6.9	10.2	27.1	24.8
Captial Goods	7.9	-0.7	13.8	13.7	2.5	15.2	37.0	38.7
Autos	-8.2	2.1	-10.0	11.5	2.0	9.6	10.1	7.9
Consumer Goods	19.0	3.2	14.3	25.3	3.0	22.9	5.5	6.1
Other	3.4	-2.3	6.0	21.3	2.5	18.1	10.2	10.2
Merchandise Imports	10.1%	-7.9%	18.4%	12.1%	12.7%	2.9%	100.0%	100.0%
Foods, Feeds, and Beverages	17.2	6.8	9.7	-0.4	0.8	-1.3	5.8	5.2
Nonpetroleum Materials	3.7	-3.8	8.0	4.4	9.5	-4.3	18.1	15.4
Petroleum	-35.9	-55.7	45.0	70.9	61.6	5.4	16.1	20.1
Capital Goods	24.2	8.1	24.3	13.8	6.9	13.8	20.8	24.1
Autos	23.4	12.3	9.8	2.3	5.7	-3.2	17.0	14.8
Consumer Goods	22.8	6.8	14.8	8.1	7.7	0.1	17.8	16.8
Other	3.1	6.6	-3.6	7.2	7.1	0.0	4.5	3.6

Note: Volume figures are based on constant 1982 dollars. Prices are fixed-weighted price indexes using 1982 weights. Trade composition is based on 1982 dollars.

Source: U.S. Department of Commerce.

for consumer goods, and there have been only fractional declines in unit sales of foreign-made automobiles.

Unfortunately, a continuation of recent trends in exports and imports is not the recipe for a prompt resolution of U.S. trade imbalances. The reason: export levels remain considerably smaller than import volumes, and, as a consequence, an export-led narrowing of the trade gap could take many years to unfold. As of the third quarter of this year, merchandise import volumes were, in fact, 57% larger than the volume of merchandise exports. If export growth settles down to a more normal 8% annualized gain and import volumes remain at their present lofty levels -- neither of which is an unrealistic assumption in light of recent trends -- it would take another six years to eliminate the merchandise trade gap. However, if import volumes kept growing at a 2% to 3% annual pace, then at least another three years could be tacked on to that time horizon. Needless to say, that's a long time to wait for meaningful progress on the foreign trade front.

Import Perils and Export Risks

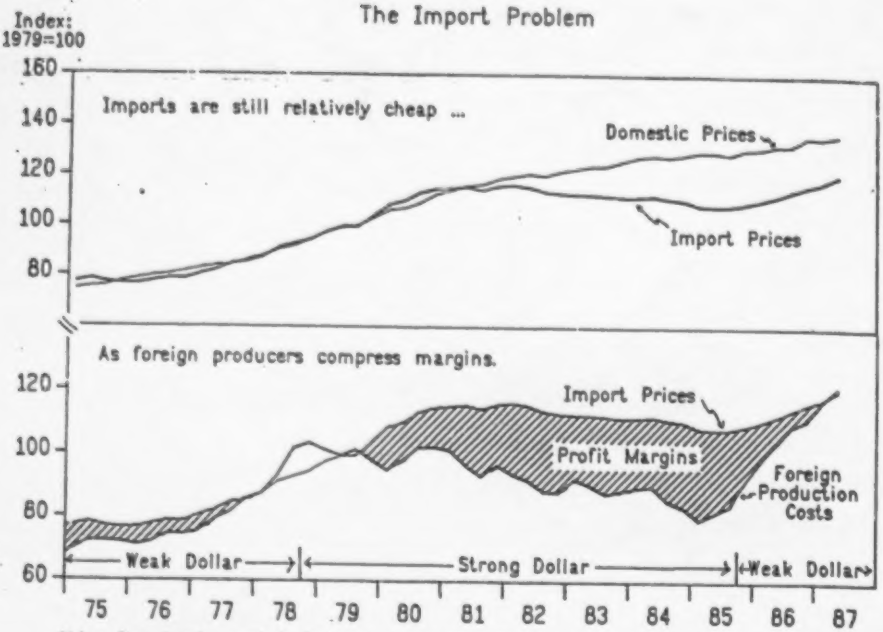
The discussion above demonstrates that America's trade dilemma is, first and foremost, a problem of excessive imports. Despite almost three years of a massive currency correction, foreign producers have continued to make inroads into our domestic markets. The fact that the volume of merchandise imports actually expanded at all over the past year -- after the dollar had fallen by over 40% from its early-1985 highs -- is quite alarming and suggests that the promises of the so-called "J-curve" have, thus far, fallen largely on deaf ears.

One key reason behind the disappointing import response is illustrated in Figure 1. Shown in the upper panel is a comparison between import prices (excluding food and energy) and prices of a comparable "basket" of American-made goods. The simple fact of the matter is that imports remain relatively cheap. To be sure, import prices have been rising at close to an 8% annual rate over the past year and a half -- more than twice the domestic inflation rate. But that improvement in relative prices follows nearly four years when declining import prices were steadily undercutting the pricing of domestically-made products. By mid-1985, our estimates suggest that the differential between domestic and import price levels had widened to almost 20 percentage points; over the past year and a half, barely one-quarter of that gap has been closed. At that pace, relative prices would not converge for another three to four years.

The lower portion of Figure 1 illustrates why dramatic currency adjustments have not produced sharply higher import prices. During the strong dollar era of 1980 to 1985, foreign producers built up an enormous reservoir of profitability on their sales of goods in the United States. As foreign currencies appreciated against the dollar over the past 2 1/2 years, a drawdown of profits was used to

Figure 1

The Import Problem



Note: Import prices exclude food and energy; domestic prices are an import-share weighted average of comparable prices as measured in the Producer Price Index. Foreign production costs are a trade-weighted average of unit labor costs in 15 countries and are converted to dollars at current exchange rates.

Source: Morgan Stanley estimates based on U.S. Department of Commerce statistics.

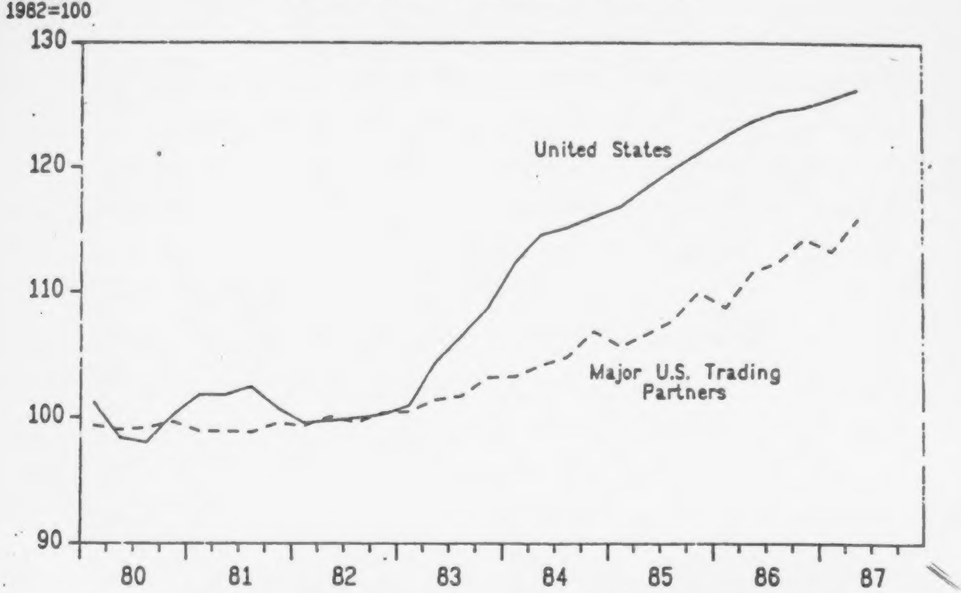
"finance" relatively limited increases in import prices. For foreign producers, such a strategy of compressing profit margins was key in facilitating a successful defense of market shares in the face of a weaker dollar. While this tactic has worked well so far, our estimates suggest that foreign producers are now at the critical breakeven point in their pricing of American imports. Consequently, additional currency pressures will be required to prompt a further realignment in relative prices that could eventually favor goods produced in the United States.

Another very important factor behind the import problem is the enormous divergence in demand between the United States and the rest of the world. As Figure 2 shows, over the past 4 1/2 years, real domestic demand has expanded by about 27% in the U.S. -- almost twice the growth of our major trading partners. Consequently, even if the import content of U.S. markets had remained stable in recent years, import volumes would have increased in line with excessive demand growth. Thus, the combination of attractive relative prices of imports, together with the disparity in demand between the U.S. and its trading partners, underscores the further risks of a rising import propensity.

It would be a mistake to conclude, however, that rapid export growth would be a desirable offset to America's voracious appetite for foreign-produced goods. The problem with such a "solution" to our trade gap is that the resulting export boom would quickly push

Figure 2

Imbalances in Domestic Demand



Note: Domestic demand is the sum of personal consumption expenditures, gross private domestic investment, and government purchases. Major U.S. trading partners include France, Italy, Canada, U.K., W. Germany, Sweden, Switzerland, Japan, Netherlands, Argentina, S. Korea, and Taiwan -- all weighted by GNP.

Source: U.S. Department of Commerce and International Monetary Fund.

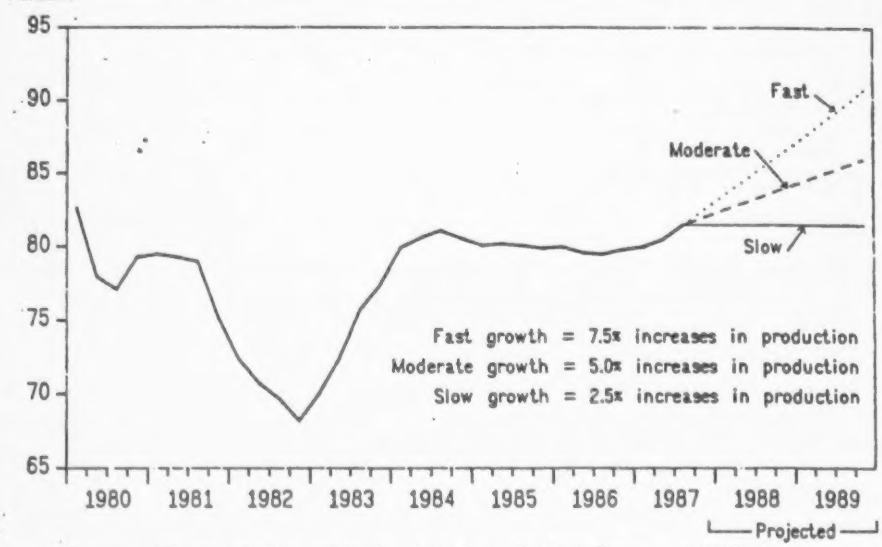
many industries against capacity constraints and trigger a new round of accelerating inflation. As Figure 3 illustrates, the factory sector operating rate has now risen above 81% and is at its highest level since early 1980. On the heels of a vigorous export expansion, industrial production rose at an 8.7% annual rate in 1987-QIII -- its sharpest rise in almost 3 1/2 years. If surging exports were to keep factory sector output rising at a pace close to the third quarter surge, then the operating rate would pierce the 90% threshold by mid-1989 (the "fast-growth" scenario). Even 5% annualized production gains would push the capacity utilization rate above the all-important 85% barrier by early 1989 (the "moderate-growth" scenario). In short, the inflation risks would be quite high if the U.S. economy were to attempt to export its way out of the trade gap.

Limited Help From Capital Goods

The macro considerations behind America's gaping trade deficit mask some important trends in key product categories. Table 2 decomposes the erosion in merchandise trade over the course of the present decade into what the Government refers to as major "end-use" product groupings. An can be seen, capital goods are the biggest contributor to the $168-billion deterioration in the real merchandise trade balance that has occurred since mid-1980. Over this seven year time frame, slippage in the capital goods trade balance has accounted for close to one-third of the cumulative erosion in total merchandise trade. Such a contribution far outdistances the portion attributable

Figure 3

Capacity Utilization in the U.S. Manufacturing Sector



Source: Morgan Stanley estimates based on Federal Reserve statistics.

Table 2

Erosion of the U.S. Merchandise Trade Balance (Based on Billions of Constant 1982 Dollars)

	1980-QIII	1987-QIII	Difference	Share of Difference
Total merchandise	$3.0	-$165.5	-$168.5	100.0%
Foods, feeds, and beverages	18.2	12.1	-6.1	3.6
Industrial supplies and materials	-46.7	-89.7	-43.0	25.5
Capital goods except autos	56.0	2.0	-54.0	32.0
Autos	-13.7	-44.5	-30.8	18.3
Consumer goods	-17.0	-58.3	-41.3	24.5
Other	6.2	13.1	6.9	-4.1

Note: Petroleum products are included in the industrial supplies and materials category.

Source: U.S. Department of Commerce.

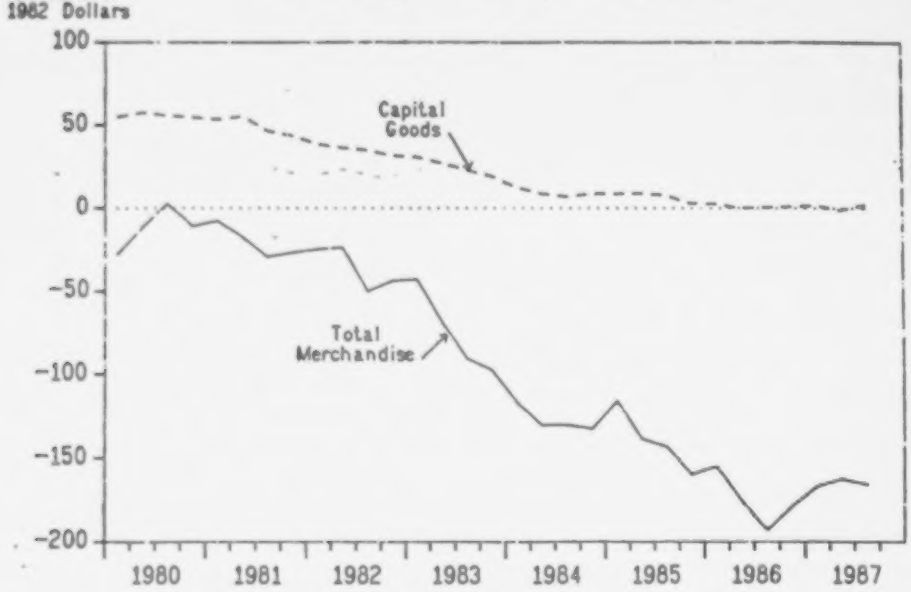
to materials and consumer products, and is nearly double the share due to trade erosion in automotive products.

As Figure 4 illustrates, the slippage in capital goods trade was especially dramatic over the 1981 to 1983 interval. The 1984 to 1985 time frame then marked the final throes of our trade surplus in this area. The balance on capital goods finally hit "zero" -- in real terms -- in 1986-QII and has bounced around near that level for the past year and a half.

Trends over the past two quarters bear special mention in light of the market's heightened fears about never-ending foreign trade gaps. From the perspective of capital goods trade, the second and third quarters of 1987 witnessed a dramatic increase in export demand. Foreign sales of U.S.-made capital goods rose at an average annual pace of 28% in volume terms -- the sharpest two-quarter gain of the present expansion. Unfortunately this spurt in exports was offset by a comparable explosion of capital goods imports; in fact, surging capital goods imports accounted for 44% of the rise in total merchandise import volumes in the two middle quarters of this year. Had the United States been able to rein in its demand for foreign-produced capital goods, the real merchandise trade gap would have narrowed appreciably over the past six months. And, who knows... the history of "Black Monday" might never have been written.

Figure 4

The Foreign Trade Gap of the 1980s



Source: U.S. Department of Commerce.

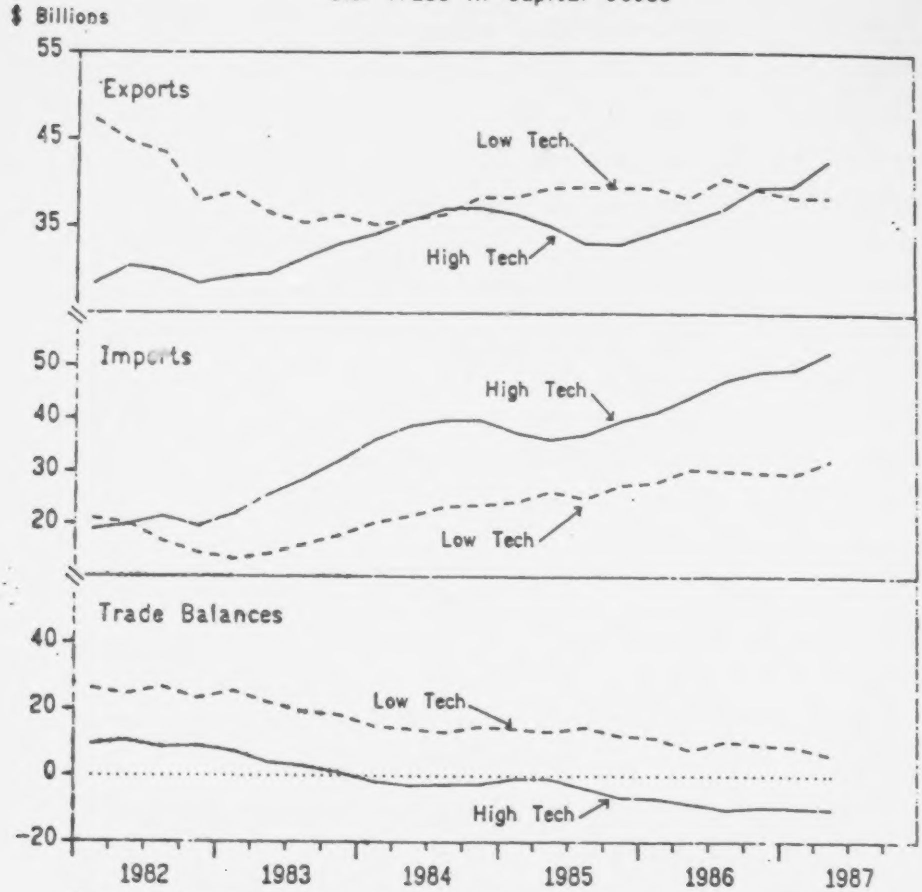
The Paradox of Technology

The plot thickens when trade in capital goods is examined in finer detail. Figure 5 decomposes capital goods trade flows into what we have referred to as "high tech" and "low tech" categories. Included as high tech capital goods are electrical machinery and electronic components, communications equipment, computers and office equipment, and scientific instruments and measuring devices; while, admittedly, this is a relatively narrow definition of the total volume of U.S. trade in high technology items, it is fairly comprehensive from the standpoint of exports and imports of capital goods. The "low tech" grouping is defined as a residual and basically includes a broad variety of industrial machinery, special industry apparatus, as well as construction industry machinery and handling equipment.

Based on this classification scheme, the trade prognosis looks especially worrisome in the high technology area. The high-tech capital goods trade balance (as measured in current dollars) slipped into deficit in late 1983, and, since then, the shortfall has widened appreciably further. From early 1985 through 1987-QII, the slippage of high tech trade accounted for 54% of the cumulative erosion of America's overall position in capital goods trade. By contrast, in the low tech area, while America's trade position also deteriorated steadily over the past five years, as of mid-1987 our estimates suggest that there is still a trade surplus of about $6-billion in these products.

Figure 5

U.S. Trade in Capital Goods



Source: Morgan Stanley estimates based in U.S. Department of Commerce statistics.

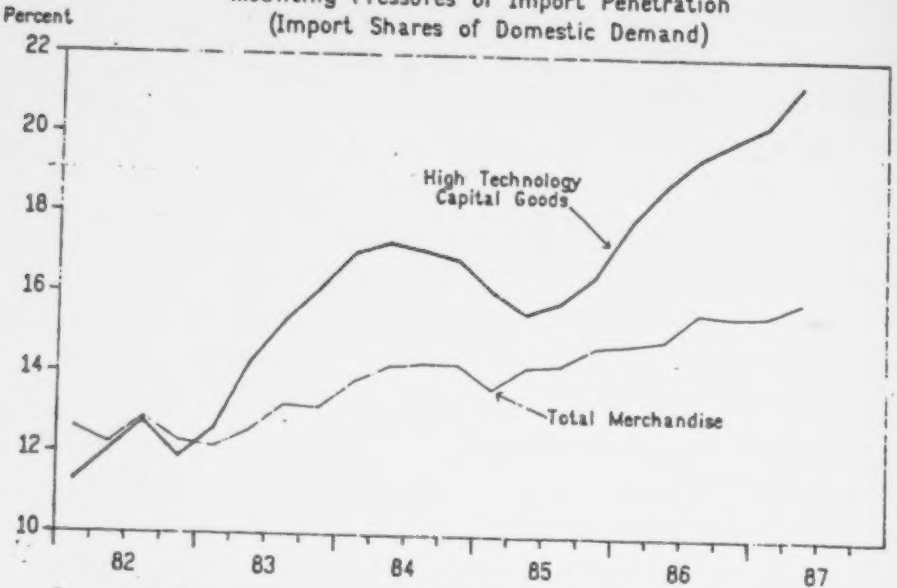
The problems in the high technology sector turn out to be little different than the overall trends in foreign trade described above. As Figure 6 illustrates, pressures on U.S. high tech producers are concentrated on the import side. This shows up clearly in an examination of "import penetration ratios" -- that share of the domestic market (shipments less exports plus imports) that can be accounted for by foreign-made products. According to our estimates, the import penetration ratio in high tech capital goods markets moved above 21% by mid-1987 -- over 5 percentage points higher than the foreign market share for total U.S. merchandise. Moreover, after trending down in late 1984 and early 1985, there has been a particularly alarming reversal over the past two years. By major commodity grouping, this recent high tech import surge was broadly based, with especially sharp gains in the computer, electronics, and communications equipment categories.

By contrast, on the export side, there is good reason for encouragement. As Figure 7 indicates, exports of high tech capital goods have clearly outperformed U.S. exports of other merchandise. Beginning in mid-1985 -- the starting point of the present surge in export demand -- high tech capital goods exports have increased by almost 30%; in comparison, total merchandise exports have risen by only about half that amount over the same two-year interval.

Clearly, foreign sales of domestically-made high tech capital goods have played an important role in sparking America's vigorous

Figure 6

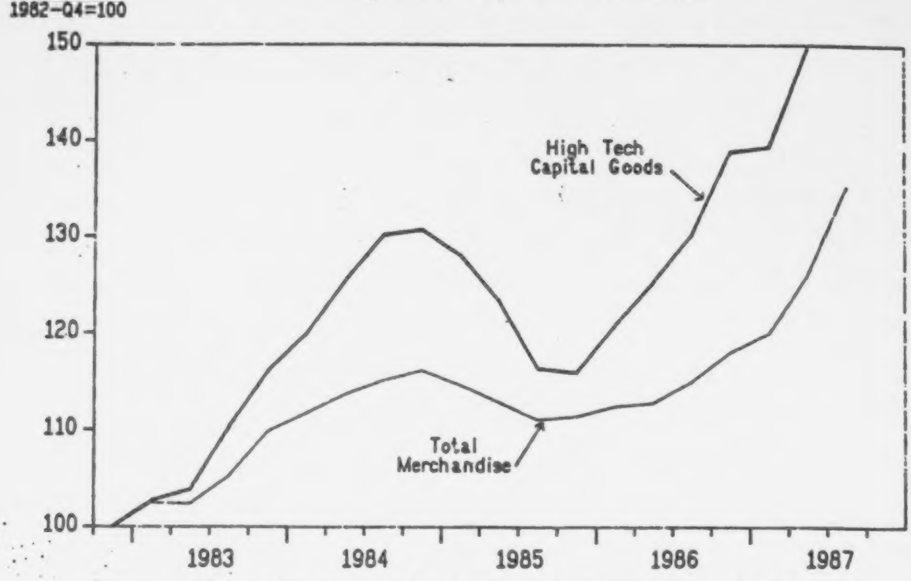
Mounting Pressures of Import Penetration
(Import Shares of Domestic Demand)



Source: Morgan Stanley estimates based on U.S. Department of Commerce statistics.

Figure 7

An Impressive Export Performance



Source: Morgan Stanley estimates based on U.S. Department of Commerce statistics.

export revival over the past couple of years. Unfortunately, this improvement has been more than offset by an explosive rise in the high technology component of capital goods imports. The net result is today's $10-billion deficit on high tech capital goods trade -- hardly suggestive of a leading-edge sector of the America economy that remains relatively invincible to the onslaught of foreign competition. Thus, high technology has not been a natural offset to a widening of the trade deficit in other areas. And if the macro underpinnings of America's trade gap are not addressed promptly by public policy, there is good reason to believe that domestic technology producers will bear a disproportionate share of any further widening of the trade deficit.

Closing the Gap

America's gaping shortfall on foreign trade is certainly one of the most intractable problems our economy has had to face since the end of World War II. And, as the above analysis has shown, it is a problem that strikes at the heart of some of our most advanced and potentially competitive industries. But there is a way out -- albeit one that does not offer instantaneous gratification.

First and foremost, our problem remains one of excessive import demand, as American consumers and businesses have developed a seemingly insatiable appetite for goods made abroad. However, as the above analysis implies, rapid import growth can eventually be arrested by the combination of a slower pace of domestic demand growth and further downward adjustments of the dollar in foreign exchange markets.

For the time being, both of these trends are presently underway. Demand is likely to slow considerably in the United States over the next year as consumers, in particular, were sent a strong signal by the stock market that they could no longer afford to keep living "beyond their means." To be sure, the pain of that realization would have been far less acute if the United States had restrained demand growth through an orderly and meaningful reduction of its Federal budget deficit. Nonetheless, for whatever the reason, slower aggregate demand growth should be reflected in lower import volumes -- a trend that, most likely, will trickle down to the high technology sector as well.

Moreover, the dollar has moved lower in recent days -- continuing a general downtrend that has been underway since early 1985. That's a clear sign that U.S. monetary authorities are now more tolerant of the fact that a weaker currency is a normal market reaction for a country faced with excessive import demand. While there could be some adverse inflationary consequences of this adjustment, a slower pace of domestic demand growth will offer slack in product markets that should offset price pressure prompted by import substitution.

The risk, however, is that relief on the import side could turn out to be nothing more than a brief respite. If next year's likely shortfall of demand growth is followed by a prompt return to trend increases, the U.S. economy could find itself right back on a path of overconsumption. And, given America's high import propensity, a painful side-effect of that outcome would be a resurgence in purchases of foreign-made goods. In this light, the most effective way to guard against excessive demand growth is by a multi-year program of responsible reductions in our Federal budget deficit. The imperatives of such actions have never been greater.

On the export side, we're doing just fine, and a detailed look at our recent experience seems to suggest that we are competing quite well in advanced technology sectors. That trend appears likely to continue -- barring a collapse in global demand. At the same time, it seems highly risky to browbeat our trading partners into faster growth in their own economies. Indeed, our analysis has shown that the United States would have a good deal of difficulty accommodating a further and sustained surge in export demand without suffering adverse inflationary consequences.

To the extent that trade adjustments are already underway, it is critical to note that any efforts to stifle marke responses by protectionist measures would be self-defeating. Our import problem can be remedied, over time, by the combination of demand and currency adjustments. And the export recovery -- which has been far more than satisfactory -- could be dealt a mortal blow by any retaliatory responses to protectionist shifts in U.S. trade policy.

While it is tempting to legislate our way out of the import problem, the ramifications of a potential contraction in global trade would be catastrophic. If industry is to regain its competitive edge it cannot be shielded from the challenges of the market place. In the long run, America must earn her share in global markets by being an efficient producer of high-quality goods. The test of our competitive resolve is at hand and there is no easy way out.

Thank you very much.

Senator **Sarbanes**. Thank you very much. We thank all of the members of the panel. I'm going to defer to Congressman Scheuer to lead off the questioning and also to express my appreciation to him for opening the hearings. I was tied up with a specially called meeting of the Iran-Contra Committee.

Representative **Scheuer**. Thank you, Mr. Chairman.

Mr. Roach, your testimony was really fascinating. You seem to say that we should dampen demand in this country for foreign high-tech products and you said a half a minute ago that our import problem can be remedied over time by the combination of demand and currency adjustments.

How do we make an adjustment in this seemingly, as you described it, insatiable demand by Americans for foreign high-tech products—Japanese cars and Japanese consumer electronics of all kinds? How do you dampen this demand except by producing a better product here at home, better in price and better in quality? Is there any other way?

Mr. **Roach**. Basically, in our judgment, we have been overconsuming as a nation. I'm not talking about cars and televisions. I'm talking about consumption levels in general.

Up until the past year, our consumption growth rates have been unprecedented for a postwar economic expansion.

Representative **Scheuer**. How do we dampen that?

Mr. **Roach**. A shift in public policy is a very effective tool that can, in fact, dampen demand. A lower budget deficit obviously would be a way of toning down excessive demand levels.

What the markets' crash showed you in mid-October is that if you won't do the job in Washington, the stock market will take enough wealth out of the system to dampen demand for you. I think that's a very strong message that should be taken from the experience of the past 2½ weeks.

Representative **Scheuer**. Indeed it was.

Mr. Bird, you talked of our still having a $40 billion trade deficit in 1992 with Japan.

Mr. **Bird**. In manufactured goods, yes.

Representative **Scheuer**. Yes, in manufactured goods. Does that assume that we're not going to make any progress with the Japanese in terms of access to their markets? I would ask you to quantify that $40 billion and break it down, disaggregate it as economists say. How much of that is due to problems of access and how much of that is due to better products at better prices? In other words, simple market forces.

Mr. **Bird**. OK.

Representative **Scheuer**. In other words, do we quote Shakespeare and say, "The fault, dear Brutus, lies not in the stars but in ourselves." How much of this is attributable to our being unable to compete in price and quality and how much of it is the bad guys who won't let us sell our products on an even playing field?

Mr. **Bird**. OK. There are several parts to that, so let me take them one at a time. The trade deficit with Japan improves to some degree. We have a $40 billion overall. I want to correct something. We have a $40 billion overall deficit and a manufactured goods deficit of $58 billion.

Representative **Scheuer**. With Japan?

Mr. **Bird**. Yes, sir. That is a very modest improvement. Today, we estimate we're running about a $60 billion deficit with Japan in manufactured goods. We get it down by only a couple of billion in this kind of scenario.

Now to answer your question, why is that happening? That is really pretty good performance. That takes, in order to do that, just to hold it where it is, growth of manufactured goods exports to Japan at 16 percent per annum—a very good export performance. It assumes barriers, if there are such, do moderate. It also assumes that this insatiable appetite for goods Mr. Roach mentioned slows down and we're growing in imports from Japan in manufactured goods at only about 4.6 percent. So the gap in growth rates dramatically reverses.

So, yes, there is some implicit assumption that there are market widening, market opening measures taken in Japan. The process the Congress and the President and the administration have taken to open up Japan to our goods we assume goes forward, more or less at the trend rate that we have observed in the recent years.

It's nothing dramatic, though, and it is more or less taking into account the normal propensities to consume by Japanese consumers and businesses and the belief that they will lose competitiveness in some areas that we still have an advantage in. Aircraft is a good example. Military goods is a good example. Certain medical equipment is a good example. We are ahead of the Japanese in many areas that we as a nation don't recognize simply because they are not consumer goods. We are ahead of them in many areas. Chemicals is another one. So there are areas where they will need goods and we can provide the goods and our dollar prices are going to be very attractive.

Nevertheless, they are very good in other areas. Their comparative advantage in automobiles is world renowned. So these figures I'm giving you imply trend improvements in market access but there is nothing dramatic in them.

You see, we start off with such a disadvantage. By our calculation, our deficit with Japan shows them to have a level of exports to us of $80 billion in manufactured goods and we have a level of exports to them of $20 billion. So that gap of 4 to 1 is a heck of a hole to dig yourself out of. So I hope that answers your question.

Representative **Scheuer**. Well, it does, but it's a very gloomy picture. If all we can do is reduce that gap by less than half a percent a year over the next 5 years, we are in real jeopardy. And if those two components for holding the line don't work out quite as well as you hope they will, that $60 billion trade deficit could go up substantially rather than go down by $2 billion.

Mr. **Bird**. Yes. Now let me make one other point because it seems like I'm Japan-bashing. There's a tendency to move in that direction. I don't want to make it that way.

Representative **Scheuer**. Nothing you said could be characterized as Japan-bashing.

Mr. **Bird**. You should be aware that Japan itself as a total nation in this picture has a deterioration in its trade surplus that's quite significant on an overall global basis. So even though they will continue to have a large trade surplus with the United States, they are increasing their imports of energy and agricultural products such that their deficit in total does decline somewhat.

Representative **Scheuer**. How come they are not increasing their imports of American agricultural products, of meat and citrus fruits, and so forth?

Mr. **Bird**. They are assumed to do that in our outlook. We show a growth in the trade surplus in primary commodities which includes these agricultural goods of some $8 billion. Our surplus with Japan does increase. It virtually doubles, but it's a small level to begin with. Our surplus in primary commodities goes from about $8 billion up to about $16 billion. It's a very slow growth, though, from the point of view of the total picture.

Now to answer your final question, what do we think would happen if all trade barriers in Japan were lowered. I'm not a student of those barriers, but of what I have studied in the way other people have done the analysis, our estimate is that it's somewhere on the order of $15 to $20 billion in total overall products, if absolutely all barriers were removed—$15 to $20 billion.

Representative **Scheuer**. So a third to a quarter of that could be removed by totally unimpeded access?

Mr. **Bird**. Yes.

Representative **Scheuer**. And then the other 75 percent has to be better products at cheaper prices.

Mr. **Bird**. Yes.

Representative **Scheuer**. Well, your testimony was fascinating, all of you. I appreciate it very much.

Thank you, Mr. Chairman.

Senator **Sarbanes**. Congressman McMillan.

Representative **McMillan**. I'm going to have to leave shortly, but I have one question to follow on Congressman Scheuer's. The chairman raised with another panel the other day when we were discussing the U.S. budget deficit vis-a-vis other economies, and we got to talking about the sharp imbalance in the magnitude of defense expenditures on the part of the United States vis-a-vis our trading partners. Six to seven percent of GNP in the United States versus 1 percent in Japan. Probably the average among NATO nations would be in the 4-percent range, perhaps somewhat less.

We've been running models of one sort or another. But if, for example, over a period of 5 years we could persuade the Japanese to assume a share of providing for their own defense—let's don't get into how this is done—maybe it's even contributing jointly to what is provided by others such as the United States, say in the Persian Gulf situation today. But suppose the Japanese were to move their defense expenditures from 1 to 4 percent of their GNP, just up to the average of NATO nations.

What impact would that likely have upon the trade balance of the United States and the balance of payments with the United States?

Mr. **Bird**. OK. They're both looking at me.

Representative **McMillan**. I'm not asking for specific figures, and it may be worth an exercise in looking at this to see what the impact would be because I think that this is very pertinent to the U.S. budget deficit and I'm not arguing against reducing it. I think we should do it and forcefully. But we are carrying a burden that is not carried by our trading partners with respect to defense expenditures.

Mr. **Roach**. Could I make a point while he is searching for an answer?

Senator **Sarbanes**. Who wants to rush in to answer it?

Mr. **Roach**. I would like to make a related point and then Mr. Bird, I'm certain, will have the answer. It is important to note that there are significant national defense implications of the analysis that I offered on high technology. First of all, note that defense expenditures have a very significant high-tech content. Since over 21 percent of our high-tech demand is being sourced by overseas production, in the event of an arms build-up, the United States now runs the risk of having our supply lines stretched over both oceans. We are not self-sufficient in high tech—nearly to the extent that we used to be historically. And I think this obviously has some very clear and significant implications for the structure of the defense production industry in the United States.

While this does not answer your question directly and I apologize for that, I think it's a relevant point.

Mr. **Bird**. We've done some trade dependency studies like that and we show the same thing.

Your question has to do with defense expenditures in Japan. On a rough split of defense expenditures in the United States, my recollection is hardware is something on the order of a third with manpower and other associated expenses being two-thirds.

Assuming that ratio was the same for the increment you're talking about, we're talking about 1 percent of GNP for Japan in hardware, which would be a market we could address. The 1 percent would be, to my recollection, something like a $50 billion increase—I'm sorry, it must be smaller than that. I don't have that figure in my head. It's something larger than $20 billion and smaller than $50 billion and perhaps $30 billion would be a closer estimate—$30 billion of hardware expenditures that one might conceivably address with U.S. exports and then you have to look at the mix of that. That's not insignificant as a possible market if you will. But the kind of way we would expect Japan to pay for defense, though, that I have heard about is to make them bear more burden on offset, bear more costs directly of the Middle East efforts of the United States, ask them to pay more of our housing, and so forth, in Japan and so forth. Those are the kinds of transfers back to us, not in the form of exports to them so much as it's transfers back to us.

Representative **McMillan**. Well, I was not only thinking of it in terms of, let's say any direct implications that would have on transfers of material or what have you, but the economic implications it would have on resources, and indirectly, what that may have on trade, and I think it's a very interesting issue.

To get it down to real cases, the House had to vote this year on the addition of two additional carrier battle groups which largely are for the defense of the Pacific Basin. That was before the Persian Gulf situation developed. And here we are carrying the major portion of the protection of that area. One carrier battle group costs $20 billion with a $1 billion a year annual operating cost. It gets pretty darned close to some of the issues that we are faced with and I've not seen a serious attempt in terms of its impact on economic relationships with our trading partners as to what a more equitable burden sharing would do. And I think it would help us in our decisionmaking here and abroad if we had some of that kind of information.

Mr. **Bird**. I'll go back home and make a proposal like that to my group and we'll see if we can get something going on that.

Representative **McMillan**. Good.

Representative **Scheuer**. Will my colleague yield?

Representative **McMillan**. Yes.

Representative **Scheuer**. Wouldn't another form of burden sharing be if we asked the Japanese to pick up a larger obligation in terms of loans, grants and investments in the Third World? There is a sensitivity in Asia about increasing the Japanese military presence out there in the Philippines, Taiwan, and Korea, but certainly a vast increase in their loans, grants, and investments to the Third World would be viewed constructively in the developing countries of Asia.

Mr. **Bird**. There was a plan proposed which is called the Okita plan which had some of that in it. That plan is somewhat on the shelf for the moment because of the movement of U.S. banks to unhook themselves from any serious obligation to get the Latin American economies in particular up out of the hole. In our view, that led the Japanese to back off themselves from further commitment.

So, to some extent, the Okita plan which had these intentions in mind, being a Japanese version of the Baker plan, with a larger aid component in it would have been the right direction to move had the Baker plan itself been implemented. By and large, our work indicates both plans were supportive of the direction you're going in your statement and both plans would have helped U.S. exports to Latin America and would have tended to help us cure the trade deficit problem using Third World country bilateral trade as one of the elements of curing the problem.

A great deal of the loss of our trade surplus that we opened up the decade with in 1980 was due to the debt crisis. Sure, we were running a deficit with Japan even then for $20 billion in manufactured goods alone. But that didn't matter because we were running a surplus so many other places.

Now it's trilateral or multilateral trade that we really have to start looking at and so your suggestion about helping the Latin American debtors get back on their feet would evidently help the United States relatively more than Japan. I still believe the Japanese would have been serious about the Okita plan had there been more clear evidence that we were serious—we, meaning the United States as a whole—about the Baker plan.

Representative **Scheuer**. Thank you.

Senator **Sarbanes**. Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman.

Each of you are very highly regarded economists and each of you seems to be saying that part of our trade imbalance and part of our trade problems are a result of the huge Federal budget deficit and we were told before the House Banking Committee this week that some of our stock market problems are a result of the huge budget deficit.

If asked by one of the summiteers how you would go about reducing the Federal budget deficit, how would you advise them, Mr. Roach?

Mr. **Roach**. I don't think I have any unique solutions. I've heard mentioned here this morning the standard laundry list, including six taxes. One thing I did hear that disturbed me, however, was a deferral of previously scheduled income tax reductions. I think that would have a worrisome impact on the markets. Another proposal I did not hear was some form of a national sales tax. We have almost $3 trillion of consumption in the United States and a 1-percent tax would raise something on the order of $25 to $30 billion if you exempt essentials. Oil taxes have been mentioned. Such an option, of course, is more constructive when the price of oil is below present levels. Quite simply, the revenue base is very narrow in our country right now and that is a significant element behind the excessive deficits of the 1980's.

Representative **Wylie**. What about a freeze across the board as a start?

Mr. **Roach**. It's a start, but it does not prioritize from the standpoint of national welfare where the excesses really are. Nonetheless, I think it would meet with a very constructive reaction in the marketplace.

Representative **Wylie**. Mr. Bird.

Mr. **Bird**. Well, by implication of the work I showed you, I'm very worried about the return of the energy deficit and I think it's better for our economy to have relative prices of energy compared to other inputs about the same as other countries for rational decisionmaking by our businesses in a world environment where ultimately energy prices are going to be, some day in the near future, going to be brought into line anyway.

We are using too much energy as a nation.

Representative **Wylie**. Are you suggesting a fuel tax?

Mr. **Bird**. Yes, that's where I'm leading to.

Representative **Wylie**. To reduce the budget deficit?

Mr. **Bird**. Yes, sir. I think an energy tax would be a constructive, long-term solution that would have support, especially if it was put in terms of it being aimed at a structural shift in our economy from its high energy dependency compared to other economies.

We should have in this country relative prices of energy more like other countries. As it is today, our relative prices of energy are low compared to capital and labor and, as a result, we use more of it.

Representative **Wylie**. It's not a very popular tax, though. You get the argument that those people who can least afford it are the ones that are going to have to pay it, the guy going to work in the morning in his automobile.

Mr. **Bird**. I think we should do something to then provide a safety net for those people and that can be worked out by the Congress, but I do think as a general rule we should start to think in terms of what our energy usage is compared to what it is in other countries. The fact that the major problem of the future in fixing this deficit is the tremendous 44 or so billion dollars' worth of deterioration in our energy deficit. The manufactured goods side, as Mr. Roach has indicated, is on the road to fix. The agricultural goods side is on the road to fix. And where we're really going to lose out is on this deterioration in energy. I think it should be addressed directly.

Representative **Wylie**. Thank you. Mr. Abel.

Mr. **Abel**. Well, there's so much focus on the deficit that one hears very little about the structural nature of deficit reduction and I think in some ways that can be longer term as important as the reduction of the deficit itself.

Just taking what I heard today, clearly we don't save very much at all in this country anymore—the last number I saw was 2.5 percent was the savings rate.

Mr. **Roach**. Three percent.

Mr. **Abel**. I mean, we don't save. And clearly, something has to be done to get the savings rate up in this country.

The second point, we have to increase productivity and production capacity. Mr. Roach's handout showed that it doesn't take very much export growth before you're bumping up against capacity utilization and generating inflation. We have to worry about physical plant and the productivity of that plant and I suspect that there is as much of a constraint in terms of skilled labor as there is in physical plant following that line of reasoning.

And all of this bears on competitiveness in the world economy. The laundry list of where to cut is very long. The pressure to cut is there, although some might question whether there's been enough cuts yet based on the action we've gotten so far, but I haven't seen much discussion, which may be taking place in the negotiations themselves, about the nature of the cuts as they affect this country longer term.

That scares me because I think the composition of how you cut, real versus phony and where you make the cuts, in the longer term can be just as important as whether you come down $30 billion a year in the deficit or $40 billion or $50 billion a year.

Mr. **Roach**. Could I just add another point to that, if I might?

Representative **Wylie**. Yes.

Mr. **Roach**. The share of our gross national product that is currently devoted to personal consumption is about 66 percent now. That's near an all-time high. Our savings rate at 3 percent in the third quarter of 1987 is less than half its 20-year average. Our debt burden relative to income has never been higher. We have been on a consumption binge in the United States and, in large part, that can be traced to a very expansive fiscal policy.

The suggestion that I made off the top of my head for some form of a consumption tax may sound like a bad thing for consumers who have just lost a lot of wealth in the stock market. However, we're not talking about a tax on wealth. We're talking about a tax on current spending. I don't think a 1 percent tax which raises $25 to $30 billion of revenue is going to bring the American consumer to his knees. On the other hand, if it can raise revenue and encourage people to save, that saving could then be used to help finance our budget deficit as well as promote capital formation.

Representative **Wylie**. I'm interested in the massive deterioration of the dollar in the market today. You heard me ask that of our previous witness. I saw two economists on the "Today Show" this morning talking about the impact of the deterioration of the dollar and they had a difference of opinion as to what the impact might be.

Would each of you be willing to estimate how much, if any, effect the devaluation of the dollar has had on U.S. trade prospects, and would you think that further depreciation in the dollar is something that we should look forward to with optimism or pessimism?

Mr. ROACH. We think, first of all, for a country saddled with excessive imports, that it's a perfectly natural response for the dollar to want to move lower in foreign exchange markets.

There was a clear problem brewing in our economy over the course of the summer. Policymakers decided that dollar stability was a critical objective of public policy. But there was a cost of keeping the dollar from falling and that was higher interest rates. Ultimately the backup in interest rates dashed the earnings expectations that were embedded in the lofty value of stock prices. And the rest is history.

The dollar now wants to go lower, and Secretary Baker has indicated in recent days that he is no longer uncomfortable with that objective.

How much lower should the dollar go? Our estimates suggest that the dollar needs to drop from pre-October 19 levels by about 25 to 30 percent to have an appreciable impact on our real trade gap over the next 3 to 4 years.

We think if that occurs—and I must admit we've gone a considerable distance in that direction in the last few days—that would be a constructive development. However, it's not the only answer.

At the same time that occurs, demand growth needs to be restrained in the United States. Nonetheless, a large drop in the dollar—and the sooner the better—would certainly be constructive for the U.S. trade balance over the next 2 to 3 years.

Representative WYLIE. Mr. Bird.

Mr. BIRD. In the base case you have in front of you we had already another 10 percent or so decline in the dollar built in. That base case is now somewhat overpowered by recent events. Up to date, we would guess that the dollar decline has not improved our nominal trade balance but has done a significant amount of improvement to our real trade balance, probably on the order of $30 billion in real terms in manufactured goods and about $10 billion in real terms in primary commodities. That's a rough estimate. So we have already gained something.

The overwhelming problem of what we call the J curve though has kicked up prices in effect of those imports such that the effect in nominal terms has not been in that direction but rather a deterioration by some $30 billion on balance.

So you had, to repeat, about a $30 billion improvement due to volume effects, but an overwhelming $60 billion on price effects. So the net has been a loss of $30 billion over the 2 years, as just a rough way to look at it.

What will happen in the future if you have a 25-percent decline versus our assumed 10-percent decline? We would think it would cure the problem faster but be at some costs and the costs would be somewhat higher inflation, and it would also be probably a period in which we have to look at foreign ownership coming in at a more rapid rate. Foreigners would be able to buy more of America, if you will, at a discount, and I don't believe a 25 percent further fall is necessarily as far as we have to go. I believe closer to 10 to 15 percent brings us to what we would call an equilibrium rate. There is always some overshooting in exchange markets, so the 25 percent that he's mentioning may be in fact what we get. But our judgment would be that a more reasonable drop would be closer to 10 to 15 percent.

Representative **Wylie**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Gentlemen, let me ask you this question. Did any of you predict or anticipate, at the time the value of the dollar changed sharply, that the workings of the J curve—assuming it is really working—would be as slow as they have been?

Mr. **Roach**. I wrote a report a year ago called "Waiting for the J Curve," and I argued that as long as import prices remain cheap as compared to domestic prices, we wouldn't get a J curve effect.

Senator **Sarbanes**. So that's your figure 1, right?

Mr. **Roach**. Correct. The J curve doesn't work until you have import and domestically produced goods at relatively comparable prices.

Mr. **Bird**. My meaning of it I guess is a little bit different, but what I meant to say is that effectively the movement of our dollar downward has evidently increased exports in volume terms. It has not had as much effect in nominal terms because of price effects on imports of those goods. We thought the deficit would be larger through time, in answer to your question, temporarily, and I can go back and retrieve some of those forecasts if it would help you. But the major point is that we've had a cascading of J curve effects. We had an initial fall of the dollar from April 1985 to the Plaza summit. That was the first kick. We had a further fall after the summit and these successive waves of the fall of the dollar have in effect caused the cascade of the J curve to be accumulated.

Had the dollar just fallen in one fell swoop, you would have had a shorter period of the J curve effect.

Senator **Sarbanes**. Do you want to add anything, Mr. Abel?

Mr. **Abel**. Well, just a point that's peculiar to agriculture. We've been in a period now, as the dollar has come down, where we also lowered prices of agricultural products through policy changes very sharply—by 25 percent or more. So what we've seen in fiscal 1986 and fiscal 1987 is signs of improvement of physical exports but very weak improvement on the financial side.

As we look to the future, the bulk of that price decline is now behind us and further declines will be very moderate. Now you can begin to see values and volumes moving together.

But the unique aspect of agriculture I think is different than in the nonagricultural part of the economy.

Senator **Sarbanes**. Of course, the fact is, as long as the nominal deficit continues, our current account is going to worsen because we're going to have larger carrying charges, aren't we? Isn't that one of the problems to this?

Mr. **Roach**. Certainly.

Mr. **Bird**. Absolutely.

Senator **Sarbanes**. I want to ask you this question. What are the responsibilities, in your view, of countries that are running large current account surpluses, in terms of addressing the overall problems of world economic growth?

Mr. **Bird**. At the formation time of Bretton Woods, there was a clear statement—through other policy statements by the IMF, it was a clear view in the immediate postwar period that trade imbalances were the responsibility of both surplus and deficit countries; however, that was an international agreement, which was largely arrived at with a lot of U.S. influence, and was an agreement between the United Kingdom and the United States in many respects, not even involving many others.

Since that time, most academicians have continued to say, the responsibility of imbalances is the responsibility of all, both the surplus and deficit countries. Effectively, though, markets are the enforcers of this agreement. If other countries don't take policy action to remove their surpluses, the markets do it for them, and they do it in harsh ways. They cause recessions, possibly severe ones, in debtor nations, as they did in France after the unique policy approach of the Mitterrand government, which caused massive trade deficits and, thereby, a run on the currency, and thereby forced the inflation rate up. And the fears of further devaluation, in effect, forced the French economy to tighten down.

Now that kind of effect, that market effect, can be one way by which you get correction. Effectively, the correction occurred because the possibilities of selling into that French market after that were much diminished, and therefore, countries that had been running a surplus with France found they now were running a deficit.

Now that kind of harsh fix could occur here, if the inflationary impulses from the fall of the dollar were large enough.

One of the counterparts of Stephen Roach's view on this is that as profit margins get squeezed, due to the fall of the dollar, the increase in import prices is going to be much more dramatic. That means the pressure will be off automobile manufacturers and every other manufacturer in the United States to keep prices low. Those inflationary impulses, as importers' profit margins narrow, will become greater, in addition to the competitiveness of the U.S. economy becoming greater. So we could very well see inflation up, real consumer expenditure and real personal disposal income down, and the bigger recessionary effect of the increase in import prices.

So to balance out my answer, what I am saying is, that we've got to consider the idea that these impacts of a dollar fall can have very serious consequences, and you can't take them lightly in terms of what our future may hold.

When you run everything out together, a 25-percent fall of the dollar, is too much and is not necessary. Will the markets do it anyway? That is a chance.

Senator **Sarbanes**. Yes, but the markets work, essentially, by moving against the deficit country first, don't they?

Mr. **Bird**. Yes.

Senator **Sarbanes**. Now what about the surplus countries and their responsibilities to avoid that situation from reaching——

Mr. **Bird**. I think they have a responsibility, but that is an academician's—that is sort of an academician's view of it, and I don't want to press that upon you.

Senator **Sarbanes**. Do you think the countries now running large foreign account surpluses in the world economy are assuming a commensurate share of their responsibility for the world economy?

Mr. **Bird**. In my view, the Japanese have assumed a commensurate share to a greater degree than the German policymakers, yes.

Mr. **Roach**. Let me just say that there is one thing that, over the last 5 years, history demonstrates very clearly—surplus countries have been growing much slower, relative to their potential growth rate than have deficit countries. This is reflective of an imbalance in global economic growth. This has been the notion behind the urging of U.S. policymakers to achieve more balance to global economic growth. A surplus country such as Germany can grow a lot faster than it has been growing. Even a surplus country like Japan can grow faster than it has been growing.

So there is a clear policy ramification to trade imbalances that comes right back to the choice of the growth path that policy makers have determined as being appropriate for their respective economies. In this same light, our country has been growing too fast, and, as I have tried to indicate, that is an important element of our import problem. That has to change as well.

Senator **Sarbanes**. Would you say that Japan and West Germany could make more of a contribution to addressing the world economic problem through accelerated growth of their domestic economies or through undertaking significant contributions to economic growth in the developing world?

Mr. **Roach**. Are you asking me?

Senator **Sarbanes**. Well, any member of the panel that wants to respond.

Mr. **Roach**. By accelerated growth of their own domestic economies, Germany and Japan would make a more meaningful contribution to alleviating overall trade imbalances. Such an outcome would also enable these countries to bear something closer to a fair share of global economic problems—including those of the developing world.

Senator **Sarbanes**. Yes.

Mr. **Bird**. We have run some tests on higher growth cases by Germany and Japan and higher growth cases involving those countries, as well as the developing countries, and the clear evidence is that as far as our imbalance is concerned, if only Germany stimulates or if only Japan and Germany stimulate, it takes a longer time to get the fix, than if they help, as you indicated, the growth rates of the developing countries through lowering barriers to their trade.

European tariff barriers are some of the highest in the world. They could be lowered. Japanese tariffs—Japanese trade barriers, not necessarily tariff barriers, are some of the highest in the world. They can be lowered. That would certainly help Third World countries, and those Third World countries are where our markets are.

Senator **Sarbanes**. I have one final question. Is it your contention, Mr. Roach, that the capacity utilization in the U.S. manufacturing sector is not now at such a level that it is a significant contributor to inflationary pressures?

Mr. **Roach**. No, we are not there yet. We are at 81 percent. It is higher than it has been in the present decade. The point I made though, is——

Senator **Sarbanes**. I know. And I was interested in that chart, because if you actually extend this timeframe back before 1980, wouldn't this line be up here somewhere?

Mr. **Roach**. In the latter half of the seventies, capacity utilization was pretty close to 85 percent. In the early part of the seventies, it was even higher than that. And typically—while I am cautious about throwing out rules of thumb—inflation worries tend to mount when operating rates climb into the low- to mid-80 percent region. We are not there yet.

Senator **Sarbanes**. But this capacity utilization, historically, in the postwar period, is down in this decade, is it not, compared with the sixties and the seventies?

Mr. **Roach**. It is down for one reason and that is that our demand is being sourced more through foreign production than by domestic production.

Senator **Sarbanes**. Well, I am trying to get at the point that we have some margin in here for further capacity utilization before we get any real kicker on inflationary pressures.

Mr. **Roach**. I think that is an important point, and I would differ a bit from the comments of Mr. Bird. Slack capacity is one reason why a currency depreciation from present levels would not cause a dramatic deterioration in inflation right now. In light of any softening of our economy, we presently have room on the inflation front to absorb currency impacts. And, I might add, we have much more room than if the economy was running flat out.

The chart that I have submitted in my testimony—and the accompanying hypothetical scenarios—address the question, What would happen if we tried to export our way out of the trade gap? My analysis leads me to conclude that such an outcome would lead to a sustained period of unsustainably vigorous expansion in export volumes. That, in turn, ultimately would have adverse inflationary consequences.

Senator **Sarbanes**. Was there anything in the economic situation in the early eighties that prevented the United States, had it chosen to do so, from addressing the overvaluation of the dollar?

Mr. **Bird**. In our view, the overvaluation really occurred primarily after 1981, and the dollar was at a low point in 1980 and had been pushed lower by policy action and by exhortation on the part of the Carter administration, and it was showing up in a favorable trade balance.

But to answer your question, the effect that we could have had on the dollar would have been to have a more moderate monetary policy, in our opinion. We could have kept the dollar lower by having a more relaxed monetary policy and a tighter fiscal policy.

Senator **Sarbanes**. Didn't we also have the problem that the administration and the Regan treasury wouldn't address the overvaluation of the dollar?

Mr. **Bird**. We didn't have the same degree of belief in the ability of policymakers to influence the value of the dollar. In the Carter administration, we had a deliberate view that that intervention and exhortation were viable instruments to bring the dollar down, and we had the reverse kind of—or rather, we had a—in our view, we had no such opinion expressed by the Reagan administration; that is correct.

Senator SARBANES. I talked with some European policymakers who simply could not comprehend how the United States allowed the dollar to stay at such an overvalued level for such a long period of time, with all its attendant consequences, which are now reflected in the sorts of figures that you are bringing to our attention.

Do you think that is a fair perception on their part?

Mr. ROACH. Again, as Mr. Bird said, I think, while Europeans may have had difficulty in comprehending our policies, so have many of us in the United States. Our policies were an unfortunate byproduct of a very expansive fiscal policy together with a relatively restrictive monetary policy. That policy "mix" kept interest rates high, in real terms—as the academics say.

Senator SARBANES. What were the components of that expansive fiscal policy?

Mr. BIRD. The tax cut of 1981, primarily. The excessive depreciation allowed on automobiles. Those would be my two candidates.

Senator SARBANES. How about the sharp increase in defense spending?

Mr. BIRD. I don't think that had much of a direct impact on imports. It had a significant indirect impact. But I think the personal income tax cut was the single greatest source of impetus to the economy, especially as it induced consumption and not investment and saving. That tax cut was originally aimed to be two-thirds business taxes, one-third personal. By the time it came out of the total process, it was two-thirds personal and one-third business. And I think that had a deleterious effect on the total picture. That is my personal opinion.

Senator SARBANES. Well, gentlemen, thank you very much. We appreciate your testimony.

The committee stands adjourned.

[Whereupon, at 11:40 a.m., the committee adjourned, subject to the call of the Chair.]

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